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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Release No. 34-77617; File No. S7-25-11

RIN 3235-AL10

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

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: In accordance with Section 764 of Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Securities and Exchange Commission ("SEC" or "Commission") is adopting new rules under the Securities Exchange Act of 1934 ("Exchange Act") that are intended to implement provisions of Title VII relating to business conduct standards and the designation of a chief compliance officer for security-based swap dealers and major security-based swap participants. The final rules also address the cross-border application of the rules and the availability of substituted compliance.

DATES: Effective Date: [insert date 60 days from publication in the Federal Register]. Compliance Date: The compliance dates are discussed in Section IV.B of this release.

FOR FURTHER INFORMATION CONTACT: Lourdes Gonzalez, Assistant Chief Counsel – Sales Practices, Joanne Rutkowski, Senior Special Counsel, Cindy Oh, Special Counsel, Lindsay Kidwell, Special Counsel, Stacy Puente, Special Counsel, Devin Ryan, 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. For further information on cross-border application of the rules, contact: Carol McGee, Assistant Director, Richard Gabbert, Senior Special Counsel, Joshua Kans, Senior Special Counsel, and Margaret Rubin, Special Counsel, Office of Derivatives Policy, Division of Trading and Markets, at (202) 551-5550, at the Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549.

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I. Introduction

The Commission is adopting Rules 15Fh-1 through 15Fh-6 and Rule 15Fk-1 to implement the business conduct standards and chief compliance officer ("CCO") requirements for security-based swap dealers ("SBS Dealers") and major security-based swap participants ("Major SBS Participants" and, together with SBS Dealers, "SBS Entities") as set forth in Title VII of the Dodd-Frank Act.[1] The Commission is also amending Rules 3a67-10 and 3a71-3 and adopting Rule 3a71-6 with respect to the cross-border application of the rules and the availability of substituted compliance.

The Dodd-Frank Act was enacted, among other reasons, to promote the financial stability of the United States by improving accountability and transparency in the

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

financial system.[2] The 2008 financial crisis highlighted significant issues in the over-the-counter derivatives markets, which experienced dramatic growth in the years leading up to the financial crisis and are capable of affecting significant sectors of the U.S. economy. Title VII of the Dodd-Frank Act provides for a comprehensive new regulatory framework for swaps and security-based swaps by, among other things: (1) providing for the registration and comprehensive regulation of SBS Entities, swap dealers ("Swap Dealers"), and major swap participants ("Major Swap Participants" and, together with Swap Dealers, "Swap Entities"); (2) imposing clearing and trade execution requirements for swaps and security-based swaps, subject to certain exceptions; (3) creating recordkeeping, regulatory reporting, and public dissemination requirements for swaps and security-based swaps; and (4) enhancing the rulemaking and enforcement authorities of the Commission and the Commodity Futures Trading Commission ("CFTC").

The Commission initially proposed Rules 15Fh-1 through 15Fh-6 and Rule 15Fk-1 in June 2011.[3] In May 2013, the Commission re-opened the comment period for all of its outstanding Title VII rulemakings, including the external business conduct rulemaking.[4]

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2 See Pub. L. No. 111-203, Preamble.

3 See Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 64766 (Jun. 29, 2011), 76 FR 42396 (Jul. 18, 2011) ("Proposing Release").

4 See Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps Proposed Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Release No. 69491 (May 1, 2013), 78 FR 30800 (May 23, 2013) ("Reopening Release").

The Commission received 40 comments on the Proposing Release, of which 9 were comments submitted in response to the Reopening Release.[5] Of the comments

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[5] See letters from Kenneth M. Fisher, Senior Vice President and Chief Financial Officer, Noble Energy, dated July 7, 2011 ("Noble"); Chris Barnard, dated Aug. 10, 2011 ("Barnard"); R. Glenn Hubbard, Co-Chair, Committee on Capital Markets Regulation, John L. Thornton, Co-Chair, Committee on Capital Markets Regulation, and Hal S. Scott, Director, Committee on Capital Markets Regulation, dated Aug. 26, 2011 ("CCMR"); John F. Damgard, President, Futures Industry Association, Robert Pickel, Executive Chairman, International Swaps and Derivatives Association, Inc., and Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, Securities Industry and Financial Markets Association, dated Aug. 26, 2011 ("FIA/ISDA/SIFMA"); Gerald W. McEntee, President, American Federation of State, County and Municipal Employees, dated Aug. 29, 2011 ("AFSCME"); Mark Hepsworth, President, Institutional Business, Interactive Data Corporation, dated Aug. 29, 2011 ("IDC"); Sen. Carl Levin, U.S. Senate, dated Aug. 29, 2011 ("Levin"); Susan N. Kelly, Senior Vice President of Policy Analysis and General Counsel, American Public Power Association, and Noreen Roche-Carter, Chair, Tax and Finance Task Force, Large Public Power Council, dated Aug. 29, 2011 ("APPA"); Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, dated Aug. 29, 2011 ("MFA"); Dennis M. Kelleher, President & CEO, and Stephen W. Hall, Securities Specialist, Better Markets, Inc., dated Aug. 29, 2011 ("Better Markets (August 2011)"); Christopher A. Klem and Molly Moore, Ropes & Gray LLP, dated Aug. 29, 2011 ("Ropes & Gray"); Joanne T. Medero, BlackRock, Inc., dated Aug. 29, 2011 ("BlackRock"); Joseph Dear, Chief Investment Officer, California Public Employees' Retirement System, Jennifer Paquette, Chief Investment Officer, Colorado PERA, Keith Bozarth, Executive Director, State of Wisconsin Investment Board, Brian Guthrie, Executive Director, Teacher Retirement System of Texas, and Rick Dahl, Chief Investment Officer, Missouri State Employees' Retirement System, dated Aug. 29, 2011 ("CalPERS (August 2011)"); Barbara Roper, Director of Investor Protection, Consumer Federation of America, Marcus Stanley, Policy Director, Americans for Financial Reform, and Michael Greenberger, Law School Professor and Founder & Director, University of Maryland Center for Health & Homeland Security, dated Aug. 29, 2011 ("CFA"); American Benefits Council, dated Aug. 29, 2011 ("ABC"); Jeff Gooch, Chief Executive Officer, MarkitSERV, dated Aug. 29, 2011 ("MarkitSERV"); Timothy W. Cameron, Esq. Managing Director, Asset Management Group, Securities Industry and Financial Markets Association, dated Aug. 29, 2011 ("SIFMA (August 2011)"); John D. Walda, President and Chief Executive Officer, National Association of College and University Business Officers, dated Aug. 29, 2011 ("NACUBO"); Kevin Gould, President, Markit North America, Inc., dated Aug. 29, 2011 ("Markit"); Daniel F. C. Crowley,

Partner, K&L Gates LLP, on behalf of the Church Alliance, dated Aug. 29, 2011 ("Church Alliance (August 2011)"); Christopher J. Ailman, California State Teachers' Retirement System, dated Aug. 30, 2011 ("CalSTRS"); John M. McNally, National Association of Bond Lawyers, dated Sept. 1, 2011 ("NABL"); Colette J. Irwin-Knott, National Association of Independent Public Finance Advisors, dated Sept. 6, 2011 ("NAIPFA"); ABA Securities Association, American Council of Life Insurers, Financial Services Roundtable, Futures Industry Association, Institute of International Bankers, International Swaps and Derivatives Association, and Securities Industry and Financial Markets Association, dated Sept. 8, 2011 ("ABA Securities Association"); Kent A. Mason, Davis & Harman LLP, dated Sept. 15, 2011 ("Mason"); Senator Tim Johnson, Chairman, U.S. Senate Committee on Banking, Housing, and Urban Affairs, and Representative Barney Frank, U.S. House Committee on Financial Services, dated Oct. 4, 2011 ("Johnson"); Lawrence B. Patent, K&L Gates LLP, on behalf of the Church Alliance, dated Oct. 4, 2011 ("Church Alliance (October 2011)"); Joseph Dear, Chief Investment Officer, California Public Employees' Retirement System et al., dated Oct. 4, 2011 ("CalPERS (October 2011)"); Susan Gaffney Director, Federal Liaison Center, Government Finance Officers Association, dated Oct. 31, 2011 ("GFOA"); Jeffery W. Rubin, Chair, Federal Regulation of Securities Committee, American Bar Association Business Law Section and Nir D. Yarden, Chair, Institutional Investors Committee, American Bar Association, dated Dec. 7, 2011 ("ABA Committees"); Bruce E. Stern, Chairman, Association of Financial Guaranty Insurers, dated Sept. 17, 2012 ("AFGI (September 2012)"); Financial Services Roundtable, Future Industry Association, Institute of International Bankers, International Swaps and Derivatives Association, Investment Company Institute, Securities Industry and Financial Markets Association, dated May 21, 2013 ("Financial Services Roundtable"); Bruce E. Stern, Chairman, Association of Financial Guaranty Insurers, dated July 22, 2013 ("AFGI (July 2013)"); Robert Pickel, Executive Vice Chairman, International Swaps and Derivatives Association, Inc., dated July 22, 2013 ("ISDA (July 2013)"); Dennis M. Kelleher, President and CEO, and Stephen W. Hall, Securities Specialist, Better Markets, Inc., dated July 22, 2013 ("Better Markets (July 2013)"); Dennis M. Kelleher, President and CEO, Better Markets, Inc., dated Oct. 18, 2013 ("Better Markets (October 2013)"); Angie Karna, Managing Director, Legal, Nomura Global Financial Products Inc., dated Sept. 10, 2014 ("Nomura"); Kyle Brandon, Managing Director, Securities Industry and Financial Markets Association, dated Aug. 7, 2015 ("SIFMA (August 2015)"); Kyle Brandon, Managing Director, Securities Industry and Financial Markets Association, dated Sept. 23, 2015 ("SIFMA (September 2015)"); Kyle Brandon, Managing Director, Securities Industry and Financial Markets Association, dated Nov. 3, 2015 ("SIFMA (November 2015)"). The comments that the Commission received on the Proposing Release and the Reopening Release are available on the Commission's website at http://www.sec.gov/comments/s7-25-11/s72511.shtml.

directed at the Cross-Border Proposing Release,[6] five referenced the proposed external business conduct standards specifically,[7] while others addressed cross-border issues generally, such as the application of substituted compliance,[8] without specifically

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[6] Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 69490 (May 1, 2013), 78 FR 30968 (May 23, 2013) ("Cross-Border Proposing Release").

[7] See letters from Robert Pickel, International Swaps and Derivatives Association, Inc., dated Aug. 14, 2013 ("ISDA (August 2013)"); Karrie McMillan, General Counsel, Investment Company Institute and Dan Waters, Managing Director, ICI Global, dated Aug. 21, 2013 ("ICI"); Dennis M. Kelleher, President & CEO, Better Markets, Inc., Stephen W. Hall, Securities Specialist, Better Markets, Inc., and Katelynn O. Bradley, Attorney, Better Markets, Inc., dated Aug. 21, 2013 ("Better Markets (August 2013)"); Kenneth E. Bentsen, Jr., President, Securities Industry and Financial Markets Association, Walt Lukken, President & Chief Executive Officer, Futures Industry Association; and Richard M. Whiting, Executive Director and General Counsel, The Financial Services Roundtable, dated Aug. 21, 2013 ("SIFMA (August 2013)"); Matti Leppälä, Secretary General/CEO, PensionsEurope, dated Sep. 3, 2013 ("PensionsEurope"). These comment letters are available on the Commission's website at https://www.sec.gov/comments/s7-02-13/s70213.shtml.

[8] See letters from Stephen Maijoor, Chair, European Securities and Markets Authority, dated Aug. 21, 2013 ("ESMA"); Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association and Adam Jacobs, Director, Head of Markets Regulation, Alternative Investment Management Association, dated Aug. 19, 2013 ("MFA/AIMA"); Marcus Stanley, Policy Director, Americans for Financial Reform, dated Aug. 22, 2013 ("AFR"); Sarah A. Miller, Chief Executive Officer, Institute of International Bankers, dated Aug. 21, 2013 ("IIB (August 2013)"); Catherine T. Dixon, Chair, Federal Regulation of Securities Committee, American Bar Association, Business Law Section, dated Oct. 2, 2013 ("ABA (October 2013)"); Agricultural Retailers Association, Business Roundtable, Financial Executives International, National Association of Corporate Treasurers, National Association of Manufacturers, U.S. Chamber of Commerce, dated Aug. 21, 2013 ("CDEU"); Futures Options Association, dated Aug. 21, 2013 ("FOA"); Kevin Nixon, Managing Director, Institute of International Finance, dated August 8, 2013 ("IIF"); Koichi Ishikura, Executive Chief of Operations for International Headquarters, Japan Securities Dealers Association, dated Aug. 21, 2013 ("JSDA"); Patrick Pearson, European Commission, dated Aug. 21, 2013 ("EC"); Jonathan Kindred and Shigesuke Kashiwagi, Japan Financial Markets Council, dated Aug. 15, 2013.

referring to the Proposing Release. Of the comments submitted in response to the U.S. Activity Proposing Release,[9] eight addressed the proposed cross-border application of the business conduct standards.[10]

The Commission is now adopting Rules 15Fh-1 through 15Fh-6 and Rule 15Fk-1, with certain revisions suggested by commenters or designed to clarify the rules and conform them to the rules adopted by the CFTC. The principal aspects of the rules are

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The SEC Chair and Commissioners were copied on a comment letter to the CFTC in connection with the CFTC's own cross-border initiative. See letter from Sherrod Brown, U.S. Senator, Tom Harkin, U.S. Senator, Jeff Merkley, U.S. Senator, Carl Levin, U.S. Senator, Elizabeth Warren, U.S. Senator, Dianne Feinstein, U.S. Senator, to the Honorable Gary Gensler, dated May 22, 2013 ("U.S. Senators").

9 See Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity that are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent, Exchange Act Release No. 74843 (Apr. 29, 2015), 80 FR 27443 (May 13, 2015) ("U.S. Activity Proposing Release").

10 See letters from Kenneth E. Bentsen, Jr., President & CEO, Securities Industry and Financial Markets Association and Financial Services Roundtable and Rich Foster, Senior Vice President & Senior Counsel for Regulatory and Legal Affairs, Financial Services Roundtable, dated July 13, 2015 ("SIFMA/FSR (July 2015)"); Sarah A. Miller, Chief Executive Officer, Institute of International Bankers, dated July 13, 2015 ("IIB (July 2015)"); Dan Waters, Managing Director, ICI Global, dated July 13, 2015 ("ICI Global (July 2015)"); Dennis M. Kelleher, President and CEO, Stephen W. Hall, Securities Specialist, Todd Phillips, Attorney, Better Markets, Inc., dated July 13, 2015 ("Better Markets (July 2015)"); Timothy W. Cameron, Esq., Managing Director and Laura Martin, Managing Director and Associate General Counsel, Asset Management Group, Securities Industry and Financial Markets Association, dated July 13, 2015 ("SIFMA-AMG (July 2015)"); David Geen, General Counsel, International Swaps and Derivatives Association, Inc. ("ISDA (July 2015)"); Chris Barnard, dated June 26, 2015 ("Barnard (July 2015)"); Stuart J. Kaswell, Executive Vice President, Managing Director & General Counsel, Managed Funds Association, dated July 13, 2015 ("MFA (July 2015)"). These comment letters are available on the Commission's website at http://www.sec.gov/comments/s7-06-15/s70615.shtml.

briefly described immediately below. A detailed discussion of each rule follows in Sections II.A. – II.J, below.[11]

A. Summary of Final Rules

Rule 15Fh-1, as adopted, defines the scope of Rules 15Fh-1 through 15Fh-6 and Rule 15Fk-1, and provides that an SBS Entity can rely on the written representations of a counterparty or its representative to satisfy its due diligence requirements under the rules, unless it has information that would cause a reasonable person to question the accuracy of the representation.

Rule 15Fh-2, as adopted, sets forth the definitions used throughout Rules 15Fh-1 through 15Fh-6. The defined terms are discussed in connection with the rules in which they appear.

Rule 15Fh-3, as adopted, defines the business conduct requirements generally applicable to SBS Entities with respect to: (1) verification of counterparty status as an eligible contract participant ("ECP") or special entity; (2) disclosure to the counterparty of material information about the security-based swap, including material risks, characteristics, incentives, and conflicts of interest; (3) disclosure of information concerning the daily mark of the security-based swap; (4) disclosure regarding the ability of the counterparty to require clearing of the security-based swap; (5) communication with counterparties in a fair and balanced manner based on principles of fair dealing and good faith; and (6) the establishment of a supervisory and compliance infrastructure.

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[11] If any of the provisions of these rules, or the application thereof to any person or circumstance, is held to be invalid, such invalidity shall not affect other provisions or application of such provisions to other persons or circumstances that can be given effect without the invalid provision or application.

Rule 15Fh-3, as adopted, additionally requires an SBS Dealer to: (1) establish, maintain and enforce written policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each known counterparty that are necessary to conduct business with that counterparty; and (2) comply with certain suitability obligations when recommending a security-based swap, or trading strategy involving a security-based swap, to a counterparty.

Rule 15Fh-4(a), as adopted, 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.

Rule 15Fh-4(b), as adopted, sets forth particular requirements for SBS Dealers acting as advisors to special entities.[12] Specifically, an SBS Dealer that acts as an advisor to a special entity must act in the "best interests" of the special entity, and make reasonable efforts to obtain information that it needs to determine that the recommendation is in the "best interests" of the special entity.[13]

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[12] The statutory definition of "special entity" includes federal agencies, states and 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. See Rule 15Fh-2(d) (defining "special entity" to include employee benefit plans that are defined in Title I of ERISA but permitting employee benefit plans that are not subject to regulation under Title I of ERISA to elect not to be special entities).

[13] Rule 15Fh-2(a), as adopted, defines what it means to "act as an advisor" to a special entity, and provides a safe harbor under which the parties can establish that the SBS Dealer is not acting as an advisor to the special entity.

Rule 15Fh-5, as adopted, sets forth particular requirements for SBS Entities acting as counterparties to special entities. Under the rule, those SBS Entities must have a reasonable basis to believe that the counterparty has a qualified representative who: (1) has sufficient knowledge to evaluate the transaction and risks; (2) is not subject to a statutory disqualification; (3) is independent of the SBS Entity; (4) undertakes a duty to act in the best interests of the special entity; (5) makes appropriate and timely disclosures to the special entity of material information concerning the security-based swap; and (6) provides written representations regarding fair pricing and the appropriateness of the security-based swap. If the special entity is an employee benefit plan that is subject to regulation under Title I of ERISA ("ERISA plan"), these requirements are satisfied if the independent representative is a "fiduciary" under ERISA. In addition, the independent representative must be subject to pay-to-play regulation if the special entity is a "municipal entity" or a "governmental plan" as defined in Section 3 of ERISA.

Rule 15Fh-6, as adopted, imposes certain pay-to-play restrictions on SBS Dealers. The rule generally prohibits an SBS Dealer from engaging in security-based swap transactions with a "municipal entity" within two years after certain political contributions have been made to officials of the municipal entity. As with other pay-to-play rules, Rule 15Fh-6 does not prohibit political contributions.

Rule 15k-1, as adopted, requires an SBS Entity to designate a CCO and imposes certain duties and responsibilities on that CCO.

B. Cross-Border Application of the Final Rules

Rule 3a71-3(c) and related amendments to Rule 3a71-3(a), as adopted, define the scope of application of the business conduct standards described in Section 15F(h) of the

Exchange Act, and the rules and regulations thereunder (other than the rules and regulations prescribed by the Commission pursuant to Section 15F(h)(1)(B)) to SBS Dealers. As adopted, these rules require a registered U.S. SBS Dealer to comply with transaction-level business conduct requirements with respect to all of its transactions, except for certain transactions conducted through such dealer's foreign branch. The rules further require a registered foreign SBS Dealer to comply with transaction-level business conduct requirements with respect to any transaction with a U.S. person (except for a transaction conducted through a foreign branch of the U.S. person) and any transaction that the SBS Dealer arranges, negotiates, or executes using personnel located in the United States.

Rule 3a67-10(d) and related amendments to Rule 3a67-10(a), as adopted, define the scope of application of the business conduct standards described in Section 15F(h) of the Exchange Act, and the rules and regulations thereunder (other than the rules and regulations prescribed by the Commission pursuant to Section 15F(h)(1)(B)) to registered Major SBS Participants. As adopted, these rules, like those applicable to registered SBS Dealers, require a registered U.S. Major SBS Participant to comply with transaction-level business conduct requirements with respect to all of its transactions, except for certain transactions conducted through such participant's foreign branch. The rules further require a registered foreign Major SBS Participant to comply with transaction-level business conduct requirements with respect to any transaction with a U.S. person (except for a transaction conducted through a foreign branch of the U.S. person) but not any transaction with a non-U.S. person.

Finally, Rule 3a71-6, as adopted, provides a framework under which foreign SBS Dealers and foreign Major SBS Participants may seek to satisfy certain business conduct requirements under Title VII by means of substituted compliance.

In developing these final rules, including their cross-border application, we have consulted and coordinated with the CFTC and the prudential regulators[14] in accordance with the consultation mandate of the Dodd-Frank Act.[15] The Commission also has consulted and coordinated with foreign regulatory authorities through Commission staff participation in numerous bilateral and multilateral discussions with foreign regulatory authorities addressing the regulation of OTC (over-the-counter) derivatives.[16] Through these discussions and the Commission staff's participation in various international task

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[14] The term "prudential regulator" is defined in section 1a(39) of the Commodity Exchange Act, 7 U.S.C. 1a(39), and that definition is incorporated by reference in section 3(a)(74) of the Exchange Act, 15 U.S.C. 78c(a)(74). Pursuant to the definition, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Farm Credit Administration, or the Federal Housing Finance Agency (collectively, the "prudential regulators") is the "prudential regulator" of a security-based swap dealer or major security-based swap participant if the entity is directly supervised by that regulator.

[15] Section 712(a)(2) of the Dodd-Frank Act provides in part that the 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."

[16] For example, senior representatives of authorities with responsibility for regulation of OTC derivatives have met on a number of occasions to discuss international coordination of OTC derivatives regulations. See, e.g., Report of the OTC Derivatives Regulators Group to G20 Leaders on Cross-Border Implementation Issues November 2015 (Nov. 2015), available at: http://www.cftc.gov/idc/groups/public/@internationalaffairs/documents/file/odrgreportg20_1115.pdf.

forces and working groups,[17] we have gathered information about foreign regulatory reform efforts and their impact on and relationship with the U.S. regulatory regime. The Commission has taken and will continue to take these discussions into consideration in developing rules, forms, and interpretations for implementing Title VII of the Dodd-Frank Act.[18]

C. Consistency with CFTC Rules

The Commission and CFTC staffs, prior to the proposal of rules by their respective agency, held approximately 30 joint meetings with interested parties regarding the agencies' respective business conduct rules to solicit a variety of views.[19] As discussed in Section I.D. below, the agencies' staffs also consulted with Department of Labor ("DOL") representatives on this rulemaking. In the Proposing Release, the Commission solicited comment on the impact of any differences between the

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17 Commission representatives participate in the Financial Stability Board's Working Group on OTC Derivatives Regulation ("ODWG"), both on the Commission's behalf and as the representative of the International Organization of Securities Commissions ("IOSCO"), which is co-chair of the ODWG. See Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed By Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, Exchange Act Release No. 77104 (February 10, 2016), 81 FR 8597 n.15 (Feb. 19, 2016) ("U.S. Activity Adopting Release"), (describing the Commission representative's role).

18 See Section 752(a) of the Dodd-Frank Act (providing 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 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.").

19 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 and at http://www.sec.gov/comments/s7-25-11/s72511.shtml.

Commission's and CFTC's approaches to business conduct regulations, and whether the Commission's proposed business conduct regulations should be modified to conform to the proposals made by the CFTC.[20] Subsequently, in February 2012, the CFTC adopted final rules with respect to the external business conduct standards of Swap Entities that are generally consistent with the Commission's proposed rules.[21] In addition, in April 2013, the CFTC adopted final rules with respect to internal business conduct standards regarding, among other things, the obligation of a Swap Entity to diligently supervise its business.[22] These rules also require each Swap Entity to designate a CCO, prescribe qualifications and duties of the CCO, and require that the CCO prepare, sign, and furnish the annual report containing an assessment of the registrant's compliance activities to either the board of directors or the senior officer.[23] The rules further require the annual report to be furnished to the CFTC.[24]

In May 2013, in the Reopening Release, the Commission sought comment on certain specific issues, including: (1) the relationship of the proposed rules to any parallel requirements of other authorities, including the CFTC and relevant foreign regulatory authorities; and (2) with respect to the CFTC rules, whether and to what extent the

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20 See Proposing Release, 76 FR at 42438, supra note 3.

21 See Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 FR 9734 (Feb. 17, 2012) ("CFTC Adopting Release").

22 See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128 (Apr. 3, 2013) ("CFTC CCO Release").

23 Id.

24 Id.

Commission, in adopting its own rules, should emphasize consistency with the CFTC rules versus adopting rules that are more tailored to the security-based swap market, including any specific examples where consistency or tailoring of a particular rule or rule set is more critically important.[25]

The Commission received numerous comments regarding consistency with the CFTC's external business conduct rules both before and after the CFTC adopted its final rules.[26] Comments specific to individual rules are addressed in the discussions of the respective rules below. As a general matter, these comments had, as an overarching theme, that the Commission should coordinate with the CFTC to achieve consistent regulations.[27] Commenters stressed that differences between the regulatory regimes would, among other things, increase regulatory burdens and costs for market participants, delay execution of transactions, and lead to confusion.[28]

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25 See Reopening Release, supra note 4.

26 See, e.g., Barnard, supra note 5; FIA/ISDA/SIFMA, supra note 5; AFSCME, supra note 5; Levin, supra note 5; APPA, supra note 5; Ropes & Gray, supra note 5; BlackRock, supra note 5; Nomura, supra note 5; GFOA, supra note 5; NABL, supra note 5; ISDA (July 2013), supra note 5; AFGI (July 2013), supra note 5; CFA, supra note 5; SIFMA (August 2015), supra note 5; SIFMA (September 2015), supra note 5; SIFMA (November 2015), supra note 5.

27 See, e.g., Barnard, supra note 5; FIA/ISDA/SIFMA, supra note 5; AFSCME, supra note 5; Levin, supra note 5; APPA, supra note 5; Ropes & Gray, supra note 5; BlackRock, supra note 5; Nomura, supra note 5; GFOA, supra note 5; NABL, supra note 5; ISDA (July 2013), supra note 5; AFGI (July 2013), supra note 5; SIFMA (August 2015), supra note 5; SIFMA, supra note 5 (September 2015); SIFMA (November 2015), supra note 5.

28 See, e.g., Barnard, supra note 5; Levin, supra note 5; BlackRock, supra note 5; NABL, supra note 5; GFOA, supra note 5.

Before the CFTC adopted its final external business conduct rules, commenters were divided as to whether they preferred the Commission's[29] or the CFTC's[30] proposed approach to specific issues, in instances in which the CFTC's proposed approach differed from the Commission's proposed rules. However, the comments received by the Commission in response to the Reopening Release, which was issued after the CFTC adopted its final rules, overwhelmingly urged the Commission to harmonize its external business conduct rules with those of the CFTC because the CFTC's rules have already been implemented by the industry.[31] A number of these comments have suggested specific and detailed modifications. Where we believe the external business conduct rules, if modified in accordance with these suggestions, will continue to provide the protections (as explained in the context of the particular rule) that the rules are intended to accomplish, we have modified the proposed rules to harmonize with CFTC

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29 See, e.g., SIFMA (August 2011), supra note 5; GFOA, supra note 5; NABL, supra note 5.

30 See, e.g., CFA, supra note 5.

31 See, e.g., Nomura, supra note 5; GFOA, supra note 5; ISDA (July 2013), supra note 5; SIFMA (August 2015), supra note 5; SIFMA (September 2015), supra note 5; SIFMA (November 2015), supra note 5.

Commenters also urged, with respect to supervision and CCO obligations ("internal" business conduct standards), that our final rules be informed by industry experience complying with the analogous Financial Industry Regulatory Authority, Inc. ("FINRA") supervision and CCO rules, as well as the CFTC internal business conduct standards. See SIFMA (September 2015), supra note 5, at 2 (urging the Commission to harmonize its rules with, among other things, "the FINRA Supervision Rules, [and] the FINRA CCO Rule").

requirements to create efficiencies for entities that have already established infrastructure for compliance with analogous CFTC requirements.[32]

D. Department of Labor ERISA Fiduciary Regulations

Section 15F(h)(2)(C) of the Exchange Act defines the term "special entity" to include "an employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974."[33]

Prior to proposing the business conduct standards rules, the Commission received submissions from commenters concerning the interaction with ERISA, DOL's proposed fiduciary rule, and current regulation regarding the definition of ERISA fiduciaries.[34] As noted above, the Commission, CFTC and DOL staffs consulted on issues regarding the intersection of ERISA fiduciary status with the Dodd-Frank Act business conduct provisions, prior to the Commission's proposing rules in this area.[35]

The Commission received numerous comments concerning the interaction of ERISA and existing fiduciary regulation with the business conduct standards under the

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32 One commenter noted that more than 17,000 entities have already adhered to a multilateral protocol that had been developed in response to the CFTC rules. See SIFMA (November 2015), supra note 5.

33 29 U.S.C. 1001 et seq. See History of EBSA and ERISA, available at http://www.dol.gov/ebsa/aboutebsa/history.html.

34 See, e.g., letter from Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, Securities Industry and Financial Markets Association and Robert G. Pickel, Executive Vice Chairman, International Swaps and Derivatives Association, Inc. to Elizabeth M. Murphy, Secretary, Commission and David A. Stawick, Secretary, CFTC (Oct. 22, 2010) ("SIFMA/ISDA 2010 Letter"), at 8 n.19. This comment letter is available on the Commission's website at http://www.sec.gov/comments/df-title-vii/swap/swap.shtml.

35 See Proposing Release, 76 FR at 42398, supra note 3.

Exchange Act and the Commission's proposed rules.[36] Commenters, including ERISA plan sponsors, dealers and institutional asset managers, stated that although ERISA plans currently use security-based swaps as part of their overall hedging or investment strategy, the statutory and regulatory intersections of ERISA and the external business conduct standards under Title VII of the Dodd-Frank Act could prevent ERISA plans from participating in security-based swap markets in the future, and the proposed business conduct standards rules, if adopted without clarification, could have unintended consequences for SBS Entities dealing with ERISA plans.[37]

Commenters were primarily concerned that compliance with the business conduct standards under the Exchange Act or the Commission's proposed rules would cause an SBS Entity to be an ERISA fiduciary to an ERISA plan and thus, subject to ERISA's prohibited transaction provisions.[38] If an SBS Entity were to become an ERISA fiduciary to an ERISA plan, it would be prohibited from entering into a security-based swap with

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36 See, e.g., ABC, supra note 5; CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; IDC, supra note 5; MFA, supra note 5; BlackRock, supra note 5; Johnson, supra note 5.

37 See, e.g., ABC, supra note 5; FIA/ISDA/SIFMA, supra note 5; IDC, supra note 5; MFA, supra note 5; BlackRock, supra note 5; Johnson, supra note 5.

38 Section 406(b) of ERISA (29 U.S.C. 1106(b)) states that an ERISA fiduciary with respect to an ERISA plan shall not (1) deal with the assets of the plan in his own interest or for his own account, (2) in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or (3) receive any consideration for his own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

that ERISA plan absent an exemption.[39] One commenter asserted that the penalties for violating ERISA's prohibited transaction provisions would discourage SBS Entities from dealing with ERISA plans.[40] Other commenters asserted that compliance by SBS Entities with the following obligations could cause an SBS Entity to be an ERISA fiduciary: (1) providing information regarding the risks of the security-based swap; (2) providing the daily mark; (3) reviewing the ability of the special entity's advisor to advise the special entity with respect to the security-based swap; and (4) acting in the best interests of the special entity.[41] Accordingly, commenters requested that the Commission and DOL coordinate the respective rules to clarify that compliance with the business conduct standards rules will not make an SBS Entity an ERISA fiduciary.[42]

DOL staff reviewed the CFTC's final business conduct standards rules for Swap Entities and provided the CFTC with the following statement:

> The Department of Labor has reviewed these final business conduct standards and concluded that they do not require swap dealers or major swap participants to engage in activities that would make them fiduciaries under the Department of Labor's current five-part test defining fiduciary advice 29 C.F.R. § 2510.3-21(c). In the Department's view, the CFTC's final business conduct standards neither conflict with the Department's existing regulations, nor compel swap dealers or major swap participants to engage in fiduciary conduct. Moreover, the Department states that it is fully committed to ensuring that any changes to the current ERISA fiduciary advice regulation are carefully harmonized with the final business conduct standards, as adopted by the CFTC and the SEC, so that

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39 In addition to other statutory exemptions, Section 408(a) of ERISA (29 U.S.C. 1108(a)) gives DOL authority to grant administrative exemptions from prohibited transactions prescribed in Section 406 of ERISA.

40 See ABC, supra note 5.

41 See, e.g., ABC, supra note 5; FIA/ISDA/SIFMA, supra note 5; IDC, supra note 5; MFA, supra note 5; BlackRock, supra note 5; Johnson, supra note 5.

42 See, e.g., ABC, supra note 5; FIA/ISDA/SIFMA, supra note 5; IDC, supra note 5; MFA, supra note 5; BlackRock, supra note 5; Johnson, supra note 5.

> there are no unintended consequences for swap dealers and major swap participants who comply with these business conduct standards.[43]

Thereafter, in April 2015, the DOL reproposed a change to the definition of fiduciary under ERISA.[44] The DOL noted that its staff had "consulted with staff of the SEC."[45]

On April 6, 2016, DOL issued its final rule.[46] We understand that DOL's revised definition of "fiduciary" in its final rule is intended to allow SBS Entities to avoid becoming ERISA fiduciaries when acting as counterparties to a swap or security-based swap transaction. For example, DOL makes the following statement in the preamble to its final rule:

> The Department has provided assurances to the CFTC and the SEC that the Department is fully committed to ensuring that any changes to the current ERISA fiduciary advice regulation are carefully harmonized with the final business conduct standards, as adopted by the CFTC and the SEC, so that there are no unintended consequences for swap and security-based swap dealers and major swap and security-based swap participants who comply with the business conduct standards. See, e.g., Letter from Phyllis C. Borzi, Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor, to The Hon. Gary Gensler et al., CFTC (Jan. 17, 2012). In this regard, we note that the disclosures required under the business conduct standards, including those regarding material information about a swap or security-based swap concerning material risks, characteristics, incentives and conflicts of interest; disclosures regarding the daily mark of a swap or security-based swap and a counterparty's clearing rights; disclosures necessary to ensure fair and

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43 See Letter from Phyllis C. Borzi, Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor to The Hon. Gary Gensler et al., CFTC (Jan. 17, 2012), CFTC Adopting Release, Appendix 2 – Statement of the Department of Labor, 77 FR 9835, supra note 21.

44 See Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 80 FR 21927 (Proposed Rule, Apr. 20, 2015).

45 Id. at 21937.

46 See Definition of the Term "Fiduciary"; Conflict of Interest Rule—Retirement Investment Advice, 81 FR 20946 (Final Rule, Apr. 8, 2016).

> balanced communications; and disclosures regarding the capacity in which a swap or security-based swap dealer or major swap participant is acting when a counterparty to a special entity, do not in the Department's view compel counterparties to ERISA-covered employee benefit plans, other plans or IRAs to make a recommendation for purposes of paragraph (a) of the final rule or otherwise compel them to act as fiduciaries in swap and security-based swap transactions conducted pursuant to section 4s of the Commodity Exchange Act and section 15F of the Securities Exchange Act. This section of this Notice discusses these issues in the context of the express provisions in the final rule on swap and security-based swap transactions and on transactions with independent fiduciaries with financial expertise.[47]

Furthermore, DOL's final rule establishes a "swap and security-based swap transactions" exclusion[48] which, in DOL's view, is intended to establish conditions under which persons acting as SBS Entities, among others, "do not become investment advice fiduciaries as a result of communications and activities conducted during the course of swap or security-based swap transactions regulated under the Dodd-Frank Act provisions in the Commodity Exchange Act or the Securities Exchange Act of 1934 and applicable CFTC and SEC implementing rules and regulations."[49] In addition, DOL has stated that its exclusion for "transactions with independent plan fiduciaries with financial expertise" has been significantly adjusted and expanded in the final rule and gives an alternative avenue for parties involved in swap, security-based swap, or other investment

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47 Id. at 20985, n. 36.

48 See id. at 20984-86 (discussing the swap and security-based swap transactions exception).

49 Id. at 20985. See also id. (explaining that in DOL's view, "when Congress enacted the swap and security based swap provisions in the Dodd-Frank Act, including those expressly applicable to ERISA covered plans, Congress did not intend that engaging in regulated conduct as part of a swap or security-based swap transaction with an employee benefit plan would give rise to additional fiduciary obligations or restrictions under Title I of ERISA").

transactions to conduct the transaction in a way that would ensure they do not become investment advice fiduciaries under the final rule.[50]

The Commission staff has continued to coordinate with DOL staff to ensure that the final business conduct standards rules are appropriately harmonized with ERISA and DOL regulations. DOL staff has provided the Commission with a statement that:

> It is the Department's view that the draft final business conduct standards do not require security-based swap dealers or major security-based swap participants to engage in activities that would make them fiduciaries under the Department's current five-part test defining fiduciary investment advice. 29 CFR § 2510.3-21(c). The standards neither conflict with the Department's existing regulations, nor compel security-based swap dealers or major security-based swap participants to engage in fiduciary conduct. Moreover, the Department's recently published final rule amending ERISA's fiduciary investment advice regulation was carefully harmonized with the SEC's business conduct standards so that there are no unintended consequences for security-based swap dealers and major security-based swap participants who comply with the business conduct standards. As explained in the preamble to the Department's final rule, the disclosures required under the SEC's business conduct rules do not, in the Department's view, compel counterparties to ERISA-covered employee benefit plans to make investment advice recommendations within the meaning of the Department's final rule or otherwise compel them to act as ERISA fiduciaries in swap and security-based swap transactions conducted pursuant to section 4s(h) of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934.[51]

Finally, the Commission has modified its proposed treatment of special entities to take into account the comprehensive regulatory scheme established under ERISA. In particular, as discussed more fully in Section II.H below, if the special entity is an ERISA

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50 See id. at 20986 (noting that DOL "does not believe extending the swap and security-based swap provisions to IRA investors is appropriate" and, rather, concluding "that it was more appropriate to address this issue in the context of the 'independent plan fiduciary with financial expertise' provision described elsewhere in this Notice").

51 See Letter from Phyllis C. Borzi, Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor to The Hon. Mary Jo White et al., SEC (Apr. 12, 2016).

plan, our rules deem certain requirements satisfied if the plan has an independent representative that is a fiduciary under ERISA.

E. Investment Adviser and Municipal Advisor Status

In addition to questions about ERISA fiduciary status, commenters also questioned whether compliance with the business conduct standards might cause an SBS Entity to be deemed an investment adviser or, when transacting with a special entity that meets the definition of municipal entity, a municipal advisor.[52] Two commenters expressed concern more generally that compliance with the daily mark requirement (in Rule 15Fh-3(c)) might raise questions as to whether an SBS Entity has advisory or fiduciary responsibilities under applicable common law, state law or federal law (e.g., DOL regulations, provisions of the Investment Advisers Act of 1940 ("Advisers Act"), or the Dodd-Frank Act's municipal advisor provisions).[53]

As we noted in the Proposing Release, the duties imposed on an SBS Dealer (or Major SBS Participant) under the business conduct rules are specific to this context, and are in addition to any duties that may be imposed under other applicable law.[54] Thus, an SBS Entity must separately determine whether it is subject to regulation as a broker-dealer, an investment adviser, a municipal advisor or other regulated entity.[55] For

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52 See, e.g., FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2011), supra note 5.

53 See FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2011), supra note 5.

54 See Proposing Release, supra note 3, 76 FR at 42424.

55 The Dodd-Frank Act amended the Exchange Act definition of "dealer" so that a person would not be deemed to be a dealer as a result of engaging in security-based swaps with eligible contract participants. See Section 3(a)(5) of the Exchange Act, 15 U.S.C. 78c(a)(5), as amended by section 761(a)(1) of the Dodd-Frank Act. The Dodd-Frank Act does not include comparable amendments for persons who act as brokers in swaps and security-based swaps. Because security-

example, 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.[56]

We further stated in the Proposing Release that an SBS Dealer that acts as an advisor to a municipal entity also may be a "municipal advisor" under Section 15B(e) of the Exchange Act.[57] We note, however, that we subsequently adopted rules in 2013 that interpret the statutorily defined term "municipal advisor" and provide a regulatory exemption for persons engaging in municipal advisory activities in circumstances in which a municipal entity or obligated person is otherwise represented by an independent registered municipal advisor with respect to the same aspects of a municipal financial product or an issuance of municipal securities so long as the following requirements are satisfied: (1) the independent registered municipal advisor is registered pursuant to Section 15B of the Exchange Act and the rules and regulations thereunder, and is not, and within at least the past two years was not, associated with the person seeking to rely on the exemption; (2) the person seeking to use the exemption receives from the municipal entity or obligated person a representation in writing that it is represented by, and will rely on the advice of, the independent registered municipal advisor, and such person has a

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based swaps, as defined in Section 3(a)(68) of the Exchange Act, are included in the Exchange Act Section 3(a)(10) definition of "security," persons who act as brokers in connection with security-based swaps must, absent an exception or exemption, register with the SEC as a broker pursuant to Exchange Act Section 15(a), and comply with the Exchange Act's requirements applicable to brokers.

As discussed in Section I.F, infra, the Commission has issued temporary exemptions under the Exchange Act in connection with the revision of the "security" definition to encompass security-based swaps. Among other aspects, these temporary exemptions extended to certain broker activities involving security-based swaps.

56 See 15 U.S.C. 80b-2(a)(11).

57 See 15 U.S.C. 78o-4(e)(4).

reasonable basis for relying on the representation; and (3) the person seeking to use the exemption provides written disclosure to the municipal entity or obligated person, with a copy to the independent registered municipal advisor, stating that such person is not a municipal advisor and is not subject to the fiduciary duty to municipal entities that the Exchange Act imposes on municipal advisors, and such disclosure is made at a time and in a manner reasonably designed to allow the municipal entity or obligated person to assess the material incentives and conflicts of interest that such person may have in connection with the municipal advisory activities.[58] We explained that if a municipal entity or obligated person is represented by a registered municipal advisor, parties to the municipal securities transaction and others who are not registered municipal advisors should be able to provide advice to the municipal entity or obligated person without being deemed themselves to be municipal advisors, so long as the responsibilities of each person are clear.[59]

F. Intersection with SRO Rules

Under the framework established in the Dodd-Frank Act, SBS Entities are not required to be members of self-regulatory organizations ("SROs"). Some commenters have, however, urged us to harmonize Title VII business conduct requirements applicable to SBS Entities with relevant SRO requirements applicable to the SRO's members to avoid unnecessary differences, which they argue could create duplication and conflicts

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58 See Registration of Municipal Advisors, Exchange Act Release No. 70462 (Sept. 20, 2013), 78 FR 67468, 67509-11 (Nov. 12, 2013) ("Municipal Advisor Registration Release").

59 Id. at 67471.

when an SBS Entity is also registered as a broker-dealer, or when an SBS Entity uses a registered broker-dealer to intermediate its transactions.[60]

The rules we proposed were designed to implement the business conduct requirements enacted by Congress regarding security-based swap activity of SBS Entities. At the same time, in proposing these rules, we were mindful that an SBS Entity also may engage in activity that will require it to register as a broker-dealer, and thus become subject to SRO rules applicable to registered broker-dealers that may impose similar business conduct requirements.[61] As we noted in the Proposing Release, the existing rules of various SROs served as an important point of reference for our proposed business conduct rules.[62] For example, a number of the proposed rules, including those regarding "know your counterparty,"[63] suitability,[64] fair and balanced communications,[65]

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60 See IIB (July 2015), supra note 10, at 13; SIFMA/FSR (July 2015), supra note 10, at 9-10 (due to the possibility of dually registered firms, the Commission and FINRA, "must work to harmonize existing sales practice requirements" because, to the extent requirements differ, "there may be unnecessary duplication and conflicts that cause a disparate impact on security-based swap dealers acting through broker-dealers as compared to other security-based swap dealers."); SIFMA (September 2015), supra note 5, at 2 (urging the Commission to harmonize its rules with, among other things, "the FINRA Supervision Rules, [and] the FINRA CCO Rule").

61 See Exchange Act Section 15(b)(8) (generally making it illegal for a registered broker-dealer to effect a transaction in, or induce or attempt to induce the purchase or sale of, any security unless it is a member of a registered securities association or effects transactions in securities solely on a national securities exchange of which it is a member). 15 U.S.C. 78o(b)(8).

62 We looked, in particular, to the requirements imposed by FINRA, the Municipal Securities Rulemaking Board ("MSRB"), and the National Futures Association ("NFA"), in addition to the business conduct standards, both internal and external, adopted by the CFTC.

63 Proposed Rule 15Fh-3(e). Cf. FINRA Rule 2090.

64 Proposed Rule 15Fh-3(f). Cf. FINRA Rules 2090 and 2111.

supervision,[66] and designation of a CCO,[67] were patterned on standards that have been established by SROs for their members. However, we tailored the proposed rules to the specifics of the regulatory scheme for security-based swaps under Title VII.[68]

We recognize, as the commenters noted, that the security-based swap and other securities activities of certain entities may require them to register both as broker-dealers and as SBS Dealers or Major SBS Participants.[69] To the extent an entity will be subject to regulation both as a broker-dealer and as an SBS Entity, there may be overlapping regulatory requirements applicable to the same activity. The Commission is mindful of potential regulatory conflicts or redundancies and has sought in adopting these final rules to avoid such conflicts and minimize redundancies, consistent with the statutory business conduct requirements for SBS Entities. As discussed throughout this release, the rules

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65 Proposed Rule 15Fh-3(g). See Exchange Act Section 15F(h)(3)C), 15 U.S.C. 78o-10(h)(3)(C). Cf. NASD Rule 2210(d)(1)(A).

66 Proposed Rule 15Fh-3(h). See Exchange Act Section 15F(h)(1)(B), 15 U.S.C. 78o-10(h)(1)(B). Cf. NASD Rules 3010 and 3012.

67 Proposed Rule 15Fk-1. See Exchange Act Section 15F(k), 15 U.S.C. 78o-10(k). Cf. FINRA Rule 3130.

68 For example, we provided in the proposed rules for an institutional suitability alternative, which was modeled on FINRA's institutional suitability rule (Rule 2111(b)) but tailored to take into account the definition of eligible contract participant included in Title VII, which includes, among other persons, individuals with aggregate amounts of more than $10 million invested on a discretionary basis (or $5 million if hedging), and entities with a net worth of at least $1 million that are hedging commercial risk. See discussion in Section II.G.4, infra. In addition, proposed Rule 15Fh-3(g) would impose obligations regarding fair and balanced communications that are consistent with, but less detailed than, the obligations imposed on registered broker-dealers under FINRA Rule 2210. See Section II.G.5, infra.

69 See, e.g., IIB (July 2015), supra note 10. In addition, as noted above, there may instances in which a registered broker-dealer acts on behalf of an SBS Entity, and so both our rules and the SRO business conduct rules may apply to the activity of the broker-dealer in its capacity as agent of the SBS Entity.

we are adopting today take into account the comments received, both comments specific to the application of the proposed rules to the security-based swap market and the role that the SBS Entities play in that market, and comments asking us to modify the proposed rules to more closely align with the similar SRO rules applicable to broker-dealers.[70] Overall, we believe that the business conduct rules we are adopting today are generally designed to be consistent with the relevant SRO requirements, taking into account the nature of the security-based swap market and the statutory requirements for SBS Entities.[71]

On July 1, 2011, the Commission issued a separate order granting temporary exemptive relief (the "Temporary Exemptions") from compliance with certain provisions of the Exchange Act in connection with the revision, pursuant to Title VII of the Dodd-Frank Act, of the Exchange Act definition of "security" to encompass security-based swaps.[72] Consistent with the Commission's action, on July 8, 2011, FINRA filed for

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70 One commenter urged harmonization with SRO (as well as CFTC) rules to allow SBS Entities "to leverage existing processes and speed implementation." SIFMA (September 2015), supra note 5, at 2.

71 Generally, 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, 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. Proposing Release, 76 FR at 42399, supra note 3.

72 See Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the Pending Revision of the Definition of "Security" Encompass Security-based Swaps, and Request for Comment, Exchange Act Release No. 64795 (Jul. 1, 2011), 76 FR 39927 (Jul. 7, 2011) (the "Exemptive Release"). The term "security-based swap" is defined in Section 761 of the Dodd-Frank Act. 15 U.S.C. 78c(a)(68). See also Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps;

immediate effectiveness FINRA Rule 0180, which, with certain exceptions, is intended to temporarily limit the application of FINRA rules with respect to security-based swaps, thereby helping to avoid undue market disruptions resulting from the change to the definition of "security" under the Act.[73]

The Commission, noting the need to avoid a potential unnecessary disruption to the security-based swap market in the absence of an extension of the Temporary Exemptions, and the need for additional time to consider the potential impact of the revision of the Exchange Act definition of "security" in light of recent Commission rulemaking efforts under Title VII of the Dodd-Frank Act, issued an order that extended

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Security-Based Swap Agreement Recordkeeping, Exchange Act Release No. 67453 (Jul. 18, 2012), 77 FR 48208 (Aug. 13, 2012) ("Products Definitions Adopting Release") for further discussion regarding the meaning of the term security-based swap.

[73] FINRA Rule 0180 temporarily limits the application of certain FINRA rules with respect to security-based swaps. See Notice of Filing and Immediate Effectiveness of Proposed Rule Change to Adopt FINRA Rule 0180 (Application of Rules to Security-Based Swaps); File No. SR-FINRA-2011-033, Exchange Act Release No. 64884 (Jul. 14, 2011), 76 FR 42755 (July 19, 2011) ("FINRA Rule 0180 Notice of Filing"). See also Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Extend the Expiration Date of FINRA Rule 0180 (Application of Rules to Security-Based Swaps); File No. SR-FINRA-2016-001, Exchange Act Release No. 76850 (Jan. 7, 2016), 81 FR 1666 (Jan. 13, 2016) (extending until February 11, 2017 the expiration date of the exemptions under FINRA Rule 0180) ("FINRA Rule 0180 Extension Notice").

In its Exemptive Release, the Commission noted that the relief is targeted and does not include, for instance, relief from the Exchange Act's antifraud and anti-manipulation provisions. FINRA has noted that FINRA Rule 0180 is similarly targeted. For instance, paragraph (a) of FINRA Rule 0180 provides that FINRA rules shall not apply to members' activities and positions with respect to security-based swaps, except for FINRA Rules 2010 (Standards of Commercial Honor and Principles of Trade), 2020 (Use of Manipulative, Deceptive or Other Fraudulent Devices), 3310 (Anti-Money Laundering Compliance Program) and 4240 (Margin Requirements for Credit Default Swaps). See also paragraphs (b) and (c) of FINRA Rule 0180 (addressing the applicability of additional rules); FINRA Rule 0180 Notice of Filing; FINRA Rule 0180 Extension Notice.

and refined the applicable expiration dates of the previously granted Temporary Exemptions.[74] In the Temporary Exemptions Extension Release, the Commission extended the expiration date of the expiring Temporary Exemptions that are not directly linked to pending security-based swap rulemakings until the earlier of such time as the Commission issues an order or rule determining whether any continuing exemptive relief is appropriate for security-based swap activities with respect to any of these Exchange Act provisions or until three years following the effective date of the Temporary Exemptions Extension Release.[75] The Commission further extended the expiration date for many expiring Temporary Exemptions directly related to pending security-based swap rulemakings until the compliance date for the related security-based swap-specific rulemaking.[76]

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74 See Order Extending Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection With the Revision of the Definition of "Security" to Encompass Security-Based Swaps, and Request for Comment, Exchange Act Release No. 71485 (Feb. 5, 2014), 79 FR 7731 (Feb. 10, 2014) ("Temporary Exemptions Extension Release"). See also Extension of Exemptions for Security-Based Swaps, Securities Act of 1933 ("Securities Act") Release No. 9545, Exchange Act Release No. 71482 (Feb. 5, 2014), 79 FR 7570 (Feb. 10, 2014) (extending the expiration dates in interim final rules that provide exemptions under the Securities Act, the Exchange Act, and the Trust Indenture Act of 1939 for those security-based swaps that prior to July 16, 2011 were security-based swap agreements and are defined as "securities" under the Securities Act and the Exchange Act as of July 16, 2011 due solely to the provisions of Title VII of the Dodd-Frank Act).

75 See Temporary Exemptions Extension Release, 79 FR at 7734, supra note 74. These Temporary Exemptions are currently scheduled to expire in February 2017.

76 Id. at 7731. The Commission extended a subset of the Temporary Exemptions until they are addressed within relevant rulemakings relating to: (i) capital, margin, and segregation requirements for security-based swap dealers and major security-based swap participants, (ii) recordkeeping and reporting requirements for security-based swap dealers and major security-based swap participants, (iii) security-based swap trade acknowledgement rules, and/or (iv) registration requirements for security-based swap execution facilities.

In establishing Rule 0180, and in extending the rule's expiration date,[77] FINRA noted its intent, pending the implementation of any Commission rules and guidance that would provide greater regulatory clarity in relation to security-based swap activities, to align the expiration date of FINRA Rule 0180 with the termination of relevant provisions of the Temporary Exemptions provided by the Commission, so as to avoid undue market disruptions resulting from the change to the definition of "security" under the Exchange Act.

II. Discussion of Rules Governing Business Conduct

A. Scope, Generally

1. Proposed Rule

Proposed Rule 15Fh-1 would provide that Rules 15Fh-1 through 15Fh-6 (governing business conduct) and Rule 15Fk-1 (requiring designation of a CCO) 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, Sections 9 and 10(b) of the Exchange Act, and the rules and regulations thereunder. Additionally, it would provide that 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 appropriate, over the term of executed security-based swaps.

In the Proposing Release, the Commission solicited comment on the scope of the business conduct rules, including whether the rules should apply to transactions between

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[77] As noted in the FINRA Rule 0180 Extension Notice, FINRA has indicated that it intends to amend the expiration date of Rule 0180 in subsequent filings as necessary such that the expiration date will be coterminous with the termination of relevant provisions of the Temporary Exemptions.

an SBS Entity and its affiliates, whether any of the rules should apply to security-based swaps that were entered into prior to the effective date of the rules, and to the extent that any of the rules were intended to provide additional protections for a particular counterparty, whether the counterparty should be able to opt out of those protections.[78]

2. Comments on the Proposed Rule

a. General

Eleven commenters addressed the general scope of the proposed business conduct standards.[79] One commenter recommended that the Commission apply the proposed rules to security-based swaps that are offered as well as those that are executed.[80] The other commenters addressed: the application of the rules to inter-affiliate transactions, the application of the rules to security-based swaps entered into prior to the effective date, and whether counterparties should be able to opt out of the protections provided by the rules.

b. Application to Security-Based Swaps Entered Into Prior to the Effective Date

Seven commenters addressed the application of the rules to security-based swaps that were entered into prior to the compliance date of the rules, and all seven

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78 See Proposing Release, 76 FR at 42401-42402, supra note 3.

79 See CFA, supra note 5; ABA Securities Association, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2011), supra note 5; NABL, supra note 5; AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5; CalPERS (August 2011), supra note 5; ABC, supra note 5; MFA, supra note 5; CalSTRS, supra note 5; SIFMA (August 2015), supra note 5.

80 See CFA, supra note 5.

recommended that the rules not apply to such transactions.[81] Three further indicated that the rules should not generally apply to amendments to, or other lifecycle events arising under, a security-based swap that was executed before the compliance date of the rules.[82] Another commenter also specifically argued that the rules should not apply to either partial or full terminations of security-based swaps executed prior to the compliance date, or the exercise of an option on a security-based swap where the option was executed prior to the compliance date.[83]

One commenter argued that amendments to existing transactions typically do not alter the risk and other characteristics of a transaction sufficiently to merit application of the rules and that application of the rules in these cases may frustrate their purpose.[84] Others believed that any potential retroactive application would be burdensome, noting that it would undermine the expectations that the parties had when entering into the security-based swap.[85]

c. Application to Inter-Affiliate Transactions

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81 See SIFMA (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5; NABL, supra note 5; AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5; ABC, supra note 5; SIFMA (August 2015), supra note 5.

82 See FIA/ISDA/SIFMA, supra note 5; NABL, supra note 5; SIFMA (August 2011), supra note 5.

83 See SIFMA (August 2015), supra note 5.

84 See FIA/ISDA/SIFMA, supra note 5.

85 See AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5; SIFMA (August 2011), supra note 5.

Three commenters discussed the application of the rules to inter-affiliate transactions.[86] All three recommended that the rules generally not apply to security-based swap transactions between affiliates,[87] but one recognized that entity-level requirements (such as CCO and supervision responsibilities) will necessarily apply.[88] One commenter asserted that the rules are intended to protect investors in arm's length transactions and therefore, would be irrelevant in inter-affiliate transactions.[89] The second commenter similarly argued that because affiliates are not "external clients" of the SBS Entity, the protections afforded by the rules are inapposite.[90] The second commenter also suggested that the Commission define "affiliate" to mean an entity that is "under common control and that reports information or prepares its financial statements on a consolidated basis" with another entity, and opined that the definition should be consistently applied across Title VII rulemakings.[91] The third commenter also advocated for a common control standard, arguing that the rules should not apply to transactions between an SBS Entity and "a person controlling, controlled by, or under common control with the [SBS Entity]."[92]

d. Counterparty Opt-Out

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86 See ABA Securities Association, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

87 See ABA Securities Association, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

88 See ABA Securities Association, supra note 5.

89 See FIA/ISDA/SIFMA, supra note 5.

90 See ABA Securities Association, supra note 5.

91 Id.

92 See SIFMA (August 2015), supra note 5.

Nine commenters addressed whether to permit counterparties to opt out of certain protections provided by the rules.[93] Six commenters were in favor of allowing an opt out in at least some circumstances,[94] and three were against it.[95]

Three commenters suggested that the Commission permit institutional or "sophisticated investors" to opt out of provisions intended to protect counterparties.[96] Specifically, one endorsed allowing "qualified institutional buyers" as defined in Rule 144A under the Securities Act and institutions with total assets of $100 million or more to opt out, asserting that the costs, delays in execution, and requirements to make detailed representations and disclosure to the SBS Entity may outweigh the benefits that such counterparties would receive.[97] Another asserted that "sophisticated" counterparties should be able to opt out of receiving "material information" disclosures and the written disclosures related to clearing rights to lower their hedging costs and avoid potential trading delays and inefficiencies.[98]

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93 See FIA/ISDA/SIFMA, supra note 5; CalPERS (August 2011), supra note 5; SIFMA (August 2011), supra note 5; ABC, supra note 5; MFA, supra note 5; CalSTRS, supra note 5; CFA, supra note 5; Better Markets (August 2011), supra note 5; Levin, supra note 5.

94 See FIA/ISDA/SIFMA, supra note 5; CalPERS (August 2011), supra note 5; SIFMA (August 2011), supra note 5; ABC, supra note 5; MFA, supra note 5; CalSTRS, supra note 5.

95 See CFA, supra note 5; Better Markets (August 2011), supra note 5; Levin, supra note 5.

96 See FIA/ISDA/SIFMA, supra note 5; CalPERS (August 2011), supra note 5; MFA, supra note 5.

97 See FIA/ISDA/SIFMA, supra note 5.

98 See MFA, supra note 5.

Three other commenters suggested an opt out for specific types of counterparties.[99] One suggested that an ERISA plan should be permitted to opt out because SBS Entities might use the information they receive as a result of compliance with the business conduct standards to disadvantage the ERISA plan.[100] A second asserted that pension funds acting as end users should be allowed to opt out of any rules that impose "heightened fiduciary duties" on SBS Dealers because pension funds do not need extra protection, and compliance with the fiduciary duties would only increase costs for SBS Dealers, leading them to either pass the costs along or refrain from entering into transactions with pension funds.[101] A third suggested that any entity advised by a qualified independent representative should be able to waive the protections of the rules to avoid execution delays and administrative costs.[102]

Three commenters opposed allowing counterparties to opt out of the special protections in the rules.[103] One commenter noted that a "theoretically optional opt out would likely become mandatory" because SBS Dealers would make it a condition of doing business, and that an opt-out approach could be used to perpetuate abuses the rules are intended to prevent.[104] Another commented that an opt-out would "only add confusion to an already complex regulatory framework and create opportunities for

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99 See ABC, supra note 5; CalSTRS, supra note 5; SIFMA (August 2011), supra note 5.

100 See ABC, supra note 5.

101 See CalSTRS, supra note 5.

102 See SIFMA (August 2011), supra note 5.

103 See CFA, supra note 5; Better Markets (August 2011), supra note 5; Levin, supra note 5.

104 See CFA, supra note 5.

market participants to evade compliance with the much-needed business conduct standards."[105] A third specifically opposed allowing counterparties to opt out of the disclosure requirements, noting that even sophisticated investors may be misled.[106]

3. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-1, predesignated as Rule 15Fh-1(a), with certain modifications.

a. General

The Commission is adopting, as proposed, the provision in final Rule 15Fh-1(a) specifying that Rules 15Fh-1 through 15Fh-6 and Rule 15Fk-1 apply "in connection with entering into security-based swaps" and also will continue to apply, as appropriate, over the term of executed security-based swaps. Many of the rules impose obligations on an SBS Entity with respect to its "counterparty" that must be satisfied before the SBS Entity has actually entered into a security-based swap with that counterparty (e.g., Rule 15Fh-3(a) (verification of counterparty status) and Rule 15Fh-3(b) (disclosure of material risks and characteristics, and material incentives or conflicts of interest)). This is consistent with the language specifying that the rules apply "in connection with entering into security-based swaps" in Rule 15Fh-1(a). Accordingly, when the rules refer to a "counterparty" of the SBS Entity, the term "counterparty" includes a potential counterparty where compliance with the obligation is required before the SBS Entity and the "counterparty" has actually entered into the security-based swap.[107]

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105 See Better Markets (August 2011), supra note 5.

106 See Levin, supra note 5.

107 We believe that our reading of the term "counterparty" to include a potential counterparty addresses the concerns raised by the commenter that requested that

b. Application to Security-Based Swaps Entered Into Prior to the Effective Date

To address concerns raised by commenters,[108] the Commission is clarifying that the business conduct rules generally will not apply to any security-based swap entered into prior to the compliance date of the rules, and generally will apply to any security-based swap entered into after the compliance date of these rules, including a new security-based swap that results from an amendment or modification to a pre-existing security-based swap.[109]

In response to commenters' concerns about applying the business conduct rules to amendments to and other lifecycle events of a security-based swap entered into before the compliance date of these rules,[110] the Commission is clarifying that the business conduct rules generally will not apply to amendments or modifications to a pre-existing security-based swap unless the amendment or modification results in a new security-based swap (and occurs after the compliance date of these rules). The Commission has previously determined that if the material terms of a security-based swap are amended or modified during its life based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula, the amended or modified security-based swap is

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the Commission apply the rules to security-based swaps that are offered as well as those that are executed. See CFA, supra note 5.

108 See SIFMA (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5; NABL, supra note 5; AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5; ABC, supra note 5; SIFMA (August 2015), supra note 5.

109 See infra Sections IV.B and C (discussing the compliance dates of these rules).

110 See FIA/ISDA/SIFMA, supra note 5; NABL, supra note 5; SIFMA (August 2015), supra note 5.

viewed as a new security-based swap.[111] Thus, if there is such a material amendment or modification, which could include a change in the economic terms of the transaction that the parties would not have provided for when entering into the security-based swap contract, the Commission will consider the amended or modified security-based swap to be a new security-based swap for purposes of the business conduct rules. If that material amendment or modification occurs after the compliance date of these rules, these rules will apply to the resulting new security-based swap.

In response to concerns raised by a commenter, the Commission also is clarifying that the rules generally will not apply to either a partial or full termination of a pre-existing security-based swap.[112] In these instances we anticipate that the expectations of the parties will be governed by the pre-existing terms of the original security-based swap, and so the business conduct requirements generally will not apply. If, however, the partial termination involves a change in the material terms of the original security-based swap "based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula" the business conduct rules will apply.

As requested by a commenter,[113] we are clarifying that the business conduct rules generally will not apply to a new security-based swap that results from the exercise of an option on a security-based swap (whether or not the exercise occurs before or after the

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111 See Products Definitions Adopting Release, supra note 72, 77 FR at 48286 ("If the material terms of a Title VII instrument are amended or modified during its life based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula, the Commissions view the amended or modified Title VII instrument as a new Title VII instrument.").

112 See SIFMA (August 2015), supra note 5.

113 Id.

compliance date of these rules), as long as the terms upon which a party can exercise the option and the terms of the underlying security-based swap that will result upon the exercise of the option are governed by the terms of the pre-existing option. If, however, the material terms of either the option or the resulting security-based swap are amended or modified based on an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula, our business conduct rules will apply to the amended or modified option or security-based swap resulting from the exercise of the option (assuming that such amendment or modification occurs after the compliance date of these rules).

We believe it appropriate to apply the rules in this manner to help to ensure that counterparties receive the benefits of the rules in circumstances where they are warranted, while providing firms adequate time to review the business conduct rules being adopted today and make appropriate changes to their operations before they have to begin complying with those rules.

The Commission emphasizes that the above clarifications relate to the business conduct rules that by their terms apply when an SBS Entity offers to enter into or enters into a security-based swap, such as verification of status (Rule 15Fh-3(a)), certain disclosures (Rule 15Fh-3(b) and (d)), requirements for special entities as counterparties (Rule 15Fh-5), and pay-to-play (Rule 15Fh-6)). Other rules being adopted today are broader in their application, such as those relating to know your counterparty (Rule 15Fh-3(e)), recommendations of security-based swaps or trading strategies (Rule 15Fh-3(f)), fair and balanced communications (Rule 15Fh-3(g)), supervision (Rule 15Fh-3(h)), antifraud (Rule 15Fh-4(a)), requirements when an SBS Dealer is acting as an advisor to a

special entity (Rule 15Fh-4(b)), and the CCO (Rule 15Fk-1). Thus, if an SBS Entity takes an action after the compliance date that independently implicates one of the business conduct rules, it will need to comply with the applicable requirements. For example, if an SBS Dealer makes a recommendation of a trading strategy that involves termination of a pre-existing security-based swap, the SBS Dealer would need to comply with the suitability requirements of Rule 15Fh-3(f) regarding such recommendation. In addition, an SBS Entity will need to comply with "entity level" rules relating to supervision and CCO after the compliance date of those rules for all of its security-based swap business.

c. Application to Inter-Affiliate Transactions

The Commission agrees with the concerns raised by commenters regarding the treatment of inter-affiliate transactions.[114] As the Commission noted in the Definitions Adopting Release (defined below), market participants may enter into inter-affiliate security-based swaps for a variety of purposes, such as to allocate risk within a corporate group or to transfer risks within a corporate group to a central hedging or treasury entity.[115] As discussed below, we believe that transactions by SBS Entities with certain of their affiliated persons do not implicate the concerns that the business conduct requirements regarding verification of counterparty status (Rule 15Fh-3(a)), disclosures regarding the product and potential conflicts of interest, daily mark and clearing rights

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114 See ABA Securities Association, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

115 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. 66868 (Apr. 27, 2012), 77 FR 30596, 30624-30625 (May 23, 2012) ("Definitions Adopting Release").

(Rule 15Fh-3(b), (c) and (d)), "know your counterparty" and suitability obligations (Rules 15Fh-3(e) and (f)), and obligations when advising or acting as counterparty to a special entity (Rules 15Fh-4(b) and 15Fh-5) are intended to address (referred to as "transaction specific obligations").[116] We therefore are providing in Rule 15Fh-1(a) as adopted that Rules 15Fh-3(a) through (f), 15Fh-4(b) and 15Fh-5 are not applicable to security-based swaps that SBS Entities enter into with certain affiliates.

We are not, however, extending the exception to transactions with all affiliates, as requested by some commenters.[117] Rather, the Commission is limiting the exception from the business conduct requirements to security-based swap transactions between majority-owned affiliates. The rule defines "majority-owned affiliates" consistent with the Definitions Adopting Release such that, for these purposes, the counterparties to a security-based swap are majority-owned affiliates if one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where "majority interest" is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting

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116 As one commenter suggested, because affiliates are not "external clients" of the SBS Entity, the protections afforded by these rules may be inapposite. See ABA Securities Association, supra note 5.

117 See SIFMA (August 2015), supra note 5; FIA/ISDA/SIFMA, supra note 5. See also ABA Securities Association, supra note 5 (suggesting an "affiliated group" definition that was considered but not adopted in the Definitions Adopting Release). As noted above, the Commissions instead adopted the exception for "majority-owned affiliates" that we are providing here. See Definitions Adopting Release, supra note 115.

securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.[118]

The transaction-specific obligations outlined above and included in Rule 15Fh-1(a) generally are designed to provide an SBS Entity counterparty with certain information in connection with the security-based swap transaction that would help reduce potential information asymmetries, and to help ensure that the SBS Entity knows its counterparty and acts in a fair manner towards that counterparty, even in the face of potential conflicts of interest. The Commission does not believe that these objectives and concerns are implicated in the same manner or to the same extent when there is an alignment of economic interests between the SBS Entity and a counterparty, such as is the case when the counterparty is a majority-owned affiliate. However, absent majority ownership, we cannot be confident that there would be an alignment of economic interests that is sufficient to eliminate the concerns that underpin the need for regulation in this area.[119] Accordingly, the Commission is modifying Rule 15Fh-1(a) to provide that Rules 15Fh-3(a)-(f), 15Fh-4(b) and 15Fh-5 are not applicable to security-based swaps that SBS Entities enter into with their majority-owned affiliates. These generally are the transaction specific exceptions requested by a commenter.[120]

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118 See Exchange Act Rules 3a71–1(d)(1) and 15Fh-1(a).

119 See Definitions Adopting Release, 77 FR at 30625, supra note 115 (declining to adopt a "common control" standard, noting that, "[a]bsent majority ownership, we cannot be confident that there would be an alignment of economic interests that is sufficient to eliminate the concerns that underpin dealer regulation.").

120 See SIFMA (August 2015), supra note 5 (requesting exceptions with respect to Rules 15Fh-3(a) through (f), 15Fh-4(b) and 15Fh-5).

Further, consistent with the commenter's request, we are not granting an exception for transactions with affiliates with respect to the antifraud requirements of Rule 15Fh-4(a) or the requirements of Rule 15Fh-3(g) (fair and balanced communications).[121] The exception for inter-affiliate transactions from the transaction specific obligations discussed above is generally predicated on the assumption that entities with aligned economic interests have an incentive to act fairly when dealing with each other. However, we believe it important to continue to provide the protections of the antifraud and fair and balanced communication rules in situations where an SBS Entity acts in a manner contrary to this assumption. We also are not granting exceptions to the entity-level requirements regarding supervision (Rule 15Fh-3(h)) and CCO obligations (Rule 15Fk-1), which are intended to help to ensure the compliance of SBS Entities in their security-based swap transactions.

d. Counterparty Opt-Out

The Commission has considered the concerns raised by commenters[122] and determined, on balance, not to permit counterparties generally to opt out of the protections provided by the business conduct rules. As discussed throughout the release in the context of specific rules, the rules being adopted today are intended to provide certain protections for counterparties, including certain heightened protections for special entities. We think it is appropriate to apply the rules so that counterparties receive the

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121 See id.

122 See FIA/ISDA/SIFMA, supra note 5; CalPERS (August 2011), supra note 5; SIFMA (August 2011), supra note 5; ABC, supra note 5; MFA, supra note 5; CalSTRS, supra note 5; CFA, supra note 5; Better Markets (August 2011), supra note 5; Levin, supra note 5.

benefits of those protections and so do not think it appropriate to permit parties generally to elect to "opt out" of the benefits of those provisions.[123]

While we are not adopting a general opt-out provision, as discussed below in connection with the relevant rules, the Commission has determined to permit means of compliance with the final rules that should promote efficiency and reduce costs (e.g., Rule 15Fh-1(b) (reliance on representations)) and, where appropriate, allow SBS Entities to take into account the sophistication of the counterparty (e.g., Rule 15Fh-3(f) (regarding recommendations of security-based swaps or trading strategies)).

B. Exceptions for Anonymous SEF or Exchange-Traded Transactions

Section 15F(h)(7) of the Exchange Act provides a statutory exception "from the requirements of this subsection" for security-based swap transactions that are: "(A) initiated by a special entity on an exchange or security-based swaps execution facility; and (B) the security-based swap dealer or major security-based swap participant does not know the identity of the counterparty to the transaction."[124] More generally, commenters have asked the Commission to provide exceptions to the application of our rules in situations in which an SBS Entity does not know the identity of its counterparty, or where a security-based swap transaction is executed on a registered national securities exchange or security-based swap execution facility ("SEF"), without regard to whether the

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[123] However, as discussed in Section II.H.1.c.iii below, in order to resolve any tension between Exchange Act Sections 15F(h)(2)(C)(iii) and (iv), we are allowing employee benefit plans that are defined in Section 3 of ERISA but not subject to Title I of ERISA to opt out of special entity status.

[124] 15 U.S.C. 78o-10(h)(7).

counterparty is a special entity.[125]

1. Proposal

Noting that there may be circumstances in which it may be unclear which party "initiated" the communications that resulted in the parties entering into a security-based swap transaction on a registered SEF or registered national securities exchange, the Commission proposed to interpret Section 15F(h)(7) to apply to any transaction with a special entity on a registered SEF or registered national securities exchange, where the SBS Entity does not know the identity of its counterparty at any time up to and including execution of a transaction.

The Commission further proposed to interpret Section 15F(h)(7) to apply with respect to requirements specific to dealings with special entities. Proposed Rule 15Fh-4(b)(3) would provide an exception from the special requirements for SBS Dealers acting as advisors to special entities, including the requirement that an SBS Dealer act in the best interests of a special entity for whom it acts as an advisor, if the transaction is executed on a registered exchange or SEF and the SBS Dealer does not know the identity of the counterparty at any time up to and including execution of the transaction. Under the same circumstances, proposed Rule 15Fh-5(c) would similarly provide an exception from the special requirements for SBS Entities acting as counterparties to special entities, including the qualified independent representative and disclosure requirements of proposed Rule 15Fh-5.[126] Proposed Rule 15Fh-6(b)(2)(iii) would provide an exception

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125 See, e.g., SIFMA (August 2011), supra note 5; BlackRock, supra note 5; FIA/ISDA/SIFMA, supra note 5.

126 See Section II.H.8, infra for a discussion of the proposed exceptions from the requirements of Rules 15Fh-4(b) and 15Fh-5.

from the pay to play rules with respect to transactions on a registered exchange or SEF where the SBS Dealer does not know the identity of the counterparty at any time up to and including execution of the transaction.[127]

Consistent with Section 15F(h)(7), we also proposed to limit the application of certain other requirements to situations in which the identity of a counterparty (whether a special entity or not) is known to the SBS Entity. The rules as proposed would limit the verification of counterparty status obligations (proposed Rule 15Fh-3(a)),[128] and know your counterparty obligations (proposed Rule 15Fh-3(e)) to transactions with counterparties whose identity is known to the SBS Entity.[129]

2. Comments on the Proposal

The Commission received five comment letters that addressed the exception for anonymous, exchange or SEF-traded security-based swaps in the context of special entity-specific requirements,[130] and four comment letters that addressed more broadly the issue of an exception for anonymous or SEF and exchange-traded security-based

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127 Rule 15Fh-6, as proposed, would apply only with respect to transactions "initiated" by a municipal entity. The Commission is modifying the exception under Rule 15Fh-6(b)(2)(iii) to apply to all security-based swap transactions that are executed on a registered national securities exchange or registered or exempt SEF, rather than just with respect to transactions "initiated by a municipal entity" on such exchange or registered SEF (as long as the other conditions of Rule 15Fh-6(b)(2)(iii) are met). These revisions are consistent with the exceptions to Rules 15Fh-4 and 15Fh-5 for anonymous, exchange-traded or SEF transactions. See Section II.H.9, infra.

128 See Section II.G.1, infra.

129 See Sections II.G.1 and II.G.3, infra.

130 See ABC, supra note 5; CFA, supra note 5; SIFMA (August 2015), supra note 5; Better Markets (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5.

swaps.[131] The comment letters that address the exception in the context of the special entity requirements are discussed infra in Sections II.H.8 and II.H.9. The comment letters that address the broader issue of an exception from business conduct requirements for anonymous or SEF and exchange-traded security-based swaps are discussed below.

Two commenters asserted that, where a security-based swap is cleared (through registered clearing organizations) and SEF or exchange-traded, the transaction should not be subject to the requirements of the proposed rules – regardless of whether the identity of the counterparty is known at the time of execution.[132] The commenters argued that knowledge or identification of a counterparty's identity should not compel compliance with the business conduct standards.[133] The commenters further argued that the concerns addressed by business conduct standards were largely inapplicable to security-based swaps entered into through registered SEFs, swap execution facilities or registered national securities exchanges.[134] The commenters asserted that compliance with the proposed rules would result in delay, additional complexity, individual negotiation and

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131 See SIFMA (August 2011), supra note 5; MFA, supra note 5; BlackRock, supra note 5; SIFMA (August 2015), supra note 5

132 See SIFMA (August 2011), supra note 5 (arguing that parties to exchange-traded security-based swaps likely know the identity of their counterparty before the transaction, either because the exchange uses a request for quote system (where the participants can seek quotes from specific counterparties) or a single-dealer platform, or because information about the counterparties to the trade is necessary to complete the execution process); BlackRock, supra note 5.

133 See SIFMA (August 2011), supra note 5 ("mere knowledge"); BlackRock, supra note 5 ("mere identification").

134 See SIFMA (August 2011), supra note 5 ("largely inapplicable"); BlackRock, supra note 5 ("simply will not be an issue").

potentially less transparency, which the trading and clearing requirements of the Dodd-Frank Act sought to avoid.[135]

However, one of the commenters acknowledged that some security-based swaps executed on a SEF or exchange might be bilaterally negotiated, and the SEF or exchange subsequently used to process the trade, in which case it might be appropriate to apply the business conduct standards.[136]

After adoption of the CFTC's business conduct standards, one commenter urged the Commission to adopt an exception for exchange-traded security-based swaps that are intended to be cleared if: (1)(a) the transaction is executed on a registered or exempt SEF or registered national securities exchange; and (b) is of a type that is, as of the date of execution, required to be cleared pursuant to Section 3C of the Exchange Act; or (2) the SBS Entity does not know the identity of the counterparty, at any time up to and including execution of the transaction.[137] The commenter argued that these changes would harmonize the scope of the Commission's requirements with the scope of the parallel requirements under the relief provided by CFTC No-Action Letter 13-70.[138] The commenter argued that the considerations on which the CFTC staff based its no-action relief would also apply to the security-based swap market, namely: "(i) the impossibility

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135 See SIFMA (August 2011), supra note 5; BlackRock, supra note 5.

136 See BlackRock, supra note 5 (also noting that, conversely, generally "when a swap or a security-based swap is cleared and exchange-traded, the counterparty to the trade should be viewed as fungible, rendering compliance with the specific requirements of [the proposed rules] unnecessary").

137 See SIFMA (August 2015), supra note 5.

138 Id. See Swaps Intended to Be Cleared, CFTC Letter No. 13-70 (Nov. 15, 2013), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/13-70.pdf.

or impracticability of compliance with certain rules by a Swap Entity when the identity of the counterparty is not known prior to execution; (ii) the likelihood that swaps initiated anonymously on a designated contract market or swap execution facility will be standardized and, thus, information about the material risks and characteristics of such swaps is likely to be available from the designated contract market or swap execution facility or other widely available source (including the product specifications of a derivatives clearing organization where the swaps are accepted for clearing); and (iii) the likelihood that such relief would provide an incentive to transact on designated contract markets and swap execution facilities, thus enhancing transparency in the swaps market."[139]

3. Response to Comments and Final Rules

After considering the comments, the Commission has determined to adopt two sets of exceptions from the business conduct requirements. As discussed in Sections II.H.8 and II.H.9, infra, we are adopting exceptions from the requirements of Rules 15Fh-4(b), 15Fh-5 and 15Fh-6 (collectively, "special entity exceptions") for anonymous transactions executed on a registered national securities exchange or a registered or exempt SEF, where the identity of the special entity is not known to the SBS Entity at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rule.[140]

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139 Id.

140 See Rules 15Fh-4(b)(3)(ii), 15Fh-5(d)(2) and 15Fh-6(b)(3)(iii). We have similarly modified the verification of special entity counterparty status requirements in Rule 15Fh-3(a)(2), as discussed infra in Section II.G.1.

In addition to the special entity exceptions, the Commission is adopting a second set of exceptions that are not limited to transactions with special entities, under which certain of the business conduct standards rules will apply only where the SBS Entity knows the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rule.[141] These exceptions are intended to address the impracticalities and potential business disruption that could result if an SBS Entity were required to comply with the disclosure requirements in Rule 15Fh-3(b) (requiring an SBS Entity to disclose material risks and characteristics of a security-based swap and material incentives or conflicts in connection with a security-based swap, prior to entering into that security-based swap with a counterparty) and Rule 15Fh-3(d) (requiring certain pre-transaction disclosures to counterparties regarding clearing rights), before learning the identity of its counterparty.[142] By only applying these rules' requirements to situations where the counterparty's identity is known "at a reasonably sufficient time prior to" the execution of a transaction, the rules' requirements are limited to situations where an SBS Entity has sufficient time before the execution of the transaction to comply with its obligations under the rules. For this reason, we decline to adopt language, suggested by a commenter, which would apply the exception to circumstances where the identity of the

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141 See ABC, supra note 5; FIA/ISDA/SIFMA, supra note 5.

142 As discussed in Section II.G.3, infra, we are adopting as proposed the exception in Rule 15Fh-3(e), which limits SBS Dealers' counterparty obligations under the rule to transactions with "known" counterparties.

counterparty "is not known at any time up to and including execution of the transaction."[143]

We are not, however, accepting the commenter's suggestion that we revise our exceptions to provide an exception for transactions intended to be cleared so long as the transaction is either executed on a registered national securities exchange or registered or exempt SEF and required to be cleared pursuant to Section 3C of the Exchange Act, regardless of whether or not the transaction is anonymous.[144] Similarly, we reject commenters' more general assertions that the exceptions should apply to all SEF or exchange-traded transactions, even where the identity of the counterparty is known,[145] and that the protections provided by the business conduct standards are unnecessary for security-based swaps that are entered into through registered SEFs, swap execution facilities or registered national securities exchanges.[146] The rules being adopted today are intended to provide certain protections for counterparties, and we think it is appropriate to apply the rules, to the extent practicable, so that counterparties receive the benefits of those protections. We have determined not to apply those rules where it may not be possible or practical to do so, specifically where a transaction is executed on a registered exchange or SEF and the identity of the counterparty is not known to the SBS Entity at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rule. However, where the identity of the counterparty is known in a timely manner, we believe that it is appropriate to apply the

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143 See SIFMA (August 2015), supra note 5.

144 Id.

145 See SIFMA (August 2011), supra note 5; BlackRock, supra note 5.

146 See SIFMA (August 2011), supra note 5.

rules so that the counterparty receives the benefits of the protections provided by the rules, including the assistance of an advisor or qualified independent representative acting in the best interests of a counterparty that is special entity.

C. Application of the Rules to SBS Dealers and Major SBS Participants

1. Proposal

As noted in the Proposing Release, in general, where the Dodd-Frank Act imposes a business conduct requirement on both SBS Dealers and Major SBS Participants, we proposed rules that would apply to SBS Dealers and Major SBS Participants.[147] Where, however, a business conduct requirement is not expressly addressed by the Dodd-Frank Act, the proposed rules generally applied only to SBS Dealers.[148] We solicited comment on whether this approach was appropriate. Specifically, where the Dodd-Frank Act requires that a business conduct rule apply to all SBS Entities, we asked if the rule should impose the same requirements on Major SBS Participants as on SBS Dealers, and where we proposed rules for SBS Dealers that are not expressly addressed by the Dodd-Frank Act, we asked if any of those rules should also apply to Major SBS Participants.

2. Comments on the Proposal

Three commenters addressed the general application of the rules to SBS Dealers

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147 See Proposing Release, 76 FR at 42400-42401, supra note 3.

148 As noted in the Proposing Release, there are exceptions to this principle. We proposed 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 proposed a rule that would require an SBS Entity to disclose to a counterparty certain information relating to these rights. See 15 U.S.C. 78c–3(g)(5); Proposing Release, 76 FR at 42401 n.39, supra note 3.

and Major SBS Participants.[149] One commenter agreed it may be appropriate, "in light of their somewhat different roles," to adopt different approaches to rules governing SBS Dealers and Major SBS Participants in certain areas.[150] The commenter asserted that absent an affirmative reason to adopt a different approach for SBS Dealers and Major SBS Participants, the Commission should seek to promote consistency and adopt uniformly strong rules.[151] The commenter argued that the determining factor should be whether Major SBS Participants are likely to be engaged in conduct that would appropriately be regulated under the relevant standard.[152]

In contrast, another commenter urged the Commission to consider separate regulatory regimes for SBS Dealers and Major SBS Participants, arguing that they are different, and there are "different reasons why the Dodd-Frank Act requires additional oversight of each."[153] The commenter recommended that the Commission focus regulation of Major SBS Participants on reducing default risk, and focus regulation of SBS Dealers on market making and pricing and sales practices in addition to reducing default risk.[154] The commenter argued that to the extent Major SBS Participants transact at arm's-length, they will not be advising counterparties and therefore, neither fiduciary duties nor "dealer-like obligations" (regarding "know your counterparty," suitability and

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149 See CFA, supra note 5; MFA, supra note 5; BlackRock, supra note 5.

150 See CFA, supra note 5.

151 Id.

152 Id.

153 See MFA, supra note 5.

154 Id.

"pay-to-play" restrictions, for example) should be imposed on them.[155]

A third commenter generally supported our proposed approach in not applying certain business conduct requirements to Major SBS Participants where the Dodd-Frank Act does not expressly impose such standards.[156] In the alternative, if the Commission determines to require Major SBS Participants to disclose "material information" and to provide daily marks to their counterparties, the commenter asked that we make these requirements inapplicable to transactions between a Major SBS Participant and an SBS Dealer, and to allow all other parties to opt out of receiving such disclosures in their dealings with a Major SBS Participant.[157]

3. Response to Comments and Final Rules

After considering the comments, the Commission has determined to apply the rules to SBS Dealers and Major SBS Participants as proposed. To that end, as discussed below, where a statutory provision encompasses both SBS Dealers and Major SBS Participants,[158] we are adopting rules that would apply equally to SBS Dealers and Major

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155 Id.

156 See BlackRock, supra note 5.

157 Id.

158 See Section 15F(h)(1) (requiring SBS Dealers and Major SBS Participants to conform to business conduct standards as prescribed by Section 15F(h)(3) (regarding duty to verify counterparty status as ECP, required pre-trade disclosures and ongoing daily mark disclosures)); Section 15F(h)(1)(A) (requiring SBS Dealers and Major SBS Participants to comply with standards as may be prescribed by the Commission regarding fraud); Section 15F(h)(1)(B) (requiring SBS Dealers and Major SBS Participants to comply with standards as may be prescribed by the Commission regarding diligent supervision of the business of the SBS Dealer or Major SBS Participant); Section 15F(h)(4)(A) (antifraud provisions applicable to both SBS Dealers and Major SBS Participants); Section 15F(h)(5) (regarding special requirements for SBS Dealers and Major SBS

SBS Participants.[159] We think this is important to ensure that counterparties of Major SBS Participants, as well as counterparties of SBS Dealers, receive the protections the rules are intended to provide. For example, to the extent that Major SBS Participants may be better informed about the risks and valuations of security-based swaps due to information asymmetries, disclosures may help inform counterparties concerning the material risks and characteristics of security-based swaps, and material conflicts of interest of Major SBS Participants entering into security-based swaps.[160]

Where, however, a business conduct requirement is not expressly addressed by the Dodd-Frank Act or we read the statute to apply a requirement only to SBS Dealers,[161] the adopted rules generally would not apply to Major SBS Participants.[162] Thus, the obligations under Rules 15Fh-3(e) (know your counterparty), 15Fh-3(f) (recommendations of security-based swaps or trading strategies), 15Fh-4(b) (special

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Participants that enter into a security-based swap with a special entity); and Section 15F(k) (imposing CCO obligations).

159 See Rules 15Fh-3(a) (verification of counterparty status), 15Fh-3(b) (pre-trade disclosures), 15Fh-3(c) (daily mark), 15Fh-3(h) (supervision), 15Fh-5 (special requirements for SBS Entities acting as counterparties to special entities) and 15Fk-1 (CCO requirements).

160 See discussion infra in Section VI.B.

161 See Section II.H.2 (regarding application of "act as an advisor" obligations under Rule 15Fh-4(b) to SBS Dealers but not Major SBS Participants).

162 As noted in the Proposing Release, there are exceptions to this principle. Because an SBS Entity must comply with the requirements of Rule 15Fh-5 if it is acting as a counterparty to a special entity, the obligation to verify special entity status under Rule 15Fh-3(a)(2) applies to all SBS Entities. See Section II.G.1. 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. As discussed in Section II.G.2.f, infra, Rule 15Fh-3(d) would require all SBS Entities to disclose to a counterparty certain information relating to these clearing rights.

obligations when acting as an advisor to a special entity) and 15Fh-6 (pay to play rules) do not apply to a Major SBS Participant. In addition, our rules provide exceptions to Major SBS Participants, as discussed in Section II.G.2.a, from certain disclosure requirements when entering into security-based swaps with an SBS Dealer, another Major SBS Participant, a swap dealer or a swap participant.

In determining whether or not to apply certain requirements to Major SBS Participants, as explained in the Proposing Release, we have 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 and our rules define "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.[163] Unlike the definition of "security-based swap dealer," which focuses on those persons whose function is to serve as the points of connection in those markets, the definition of "major security-based swap participant" focuses on the market impacts and risks associated with an entity's security-based swap positions.[164] Despite the differences in focus, however, the Dodd-Frank Act applies substantially the same statutory standards to SBS Dealers and Major SBS Participants.[165] We explained in the Proposing Release

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163 See Exchange Act Section 3(a)(71), 15 U.S.C. 78c(a)(71), and Rule 3a-71, 17 CFR 240.3a71.

164 See Exchange Act Section 3(a)(67), 15 U.S.C. 78c(a)(67), and Rule 3a-67, 17 CFR 240.3a67.

165 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. See 15 U.S.C. 78o-10.

that, in this way, the statute applies comprehensive 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.

We are mindful, as noted by a commenter, that there are "different reasons why the Dodd-Frank Act requires additional oversight of each."[166] We have attempted to take into account these differing definitions and regulatory concerns in considering whether the business conduct requirements that we proposed, and that we are adopting, for SBS Dealers should or should not apply to Major SBS Participants as well. Accordingly, as noted, in general, where the Dodd-Frank Act imposes a business conduct requirement on both SBS Dealers and Major SBS Participants, the rules will apply equally to SBS Dealers and Major SBS Participants, and where a business conduct requirement is not expressly addressed by the Dodd-Frank Act, the rules generally will not apply to Major SBS Participants. We believe this approach addresses the concern of the commenter who argued that the determining factor should be the conduct in which a Major SBS Participant is likely to be engaged.[167]

The external business conduct requirements promulgated under Section 15F(h) are intended to provide certain protections for counterparties, and we believe the rules we are adopting today appropriately apply those requirements to SBS Dealers and Major SBS Participants so that counterparties receive the benefit of those protections. At the same time, mindful of the different role to be played by Major SBS Participants (which, by definition, are not SBS Dealers), we have not sought to impose the full range of

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166 See MFA, supra note 5.

167 See CFA, supra note 5.

business conduct requirements on Major SBS Participants. We note that our approach in this regard largely mirrors that of the CFTC, under whose rules Swap Dealers and Major Swap Participants have operated for some time. We believe that this consistency will result in efficiencies for entities that have already established infrastructure to comply with the CFTC standard.

We proposed and are adopting limited exceptions (as discussed in connection with the applicable rules) from the disclosure requirements in Rules 15Fh-3(b), 15Fh-3(c) and 15Fh-3(d) for transactions with an SBS Entity or a Swap Entity.[168] We are not, however, adopting the suggestion that we broaden the exceptions to permit other types of counterparties to opt out of the disclosures and other protections provided under the rules when entering into a transaction with a Major SBS Participant. As noted above, the external business conduct requirements promulgated under Section 15F(h) are intended to provide certain protections for counterparties, and we believe the rules we are adopting today appropriately tailor those requirements so that counterparties receive the benefit of those protections.

D. Reliance on Representations

1. Proposal

The Proposing Release solicited input on whether the rules adopted by the Commission should include a standard addressing the circumstances in which an SBS Entity may rely on representations to establish compliance with the business conduct rules.[169] We sought comment on two alternative approaches.[170] One approach would

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168 See BlackRock, supra note 5.

169 See Proposing Release, 76 FR at 42404, supra note 3.

permit an SBS Entity to rely on a representation from a counterparty unless it knows that the representation is not accurate ("actual knowledge standard").[171] The other 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 ("reasonable person standard").[172] After the Commission issued its proposed rules, the CFTC in its final rules adopted a "reasonable person standard" that generally permits a Swap Entity to rely on written representations to satisfy its due diligence obligations unless it has information that would cause a reasonable person to question the accuracy of the representation.[173]

2. Comments on the Proposal

Twelve commenters generally addressed the proposed standards for reliance on counterparty representations.[174] With one exception,[175] these comments predate the 2012 adoption of the CFTC rules.

In 2011, seven commenters supported the actual knowledge standard.[176] One asserted its view that the actual knowledge standard would offer greater legal certainty to

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170 Id.

171 Id.

172 Id.

173 See CFTC Adopting Release, 77 FR at 9749, supra note 21.

174 See CCMR, supra note 5; FIA/ISDA/SIFMA, supra note 5; APPA, supra note 5; BlackRock, supra note 5; SIFMA (August 2011), supra note 5; ABC, supra note 5; ABA Committees, supra note 5; NABL, supra note 5; Better Markets (August 2011), supra note 5; AFSCME, supra note 5; CFA, supra note 5; SIFMA (August 2015), supra note 5.

175 See SIFMA (August 2015), supra note 5 (asking the Commission to adopt a reasonable person standard consistent with the standard under the parallel CFTC rules).

SBS Entities when making required subjective judgments under the rules (for example, judgments regarding the qualifications of a special entity's independent representative).[177] Another commenter argued that the actual knowledge standard is preferable because the reasonable person standard would require an assessment of what a reasonable person would conclude if such person had the same information as the SBS Entity, which could cause uncertainty and additional cost for market participants.[178]

One commenter, writing after the CFTC rules were adopted, asked the Commission to adopt a "reasonable person standard" that is "consistent with the parallel CFTC EBC Rules," which generally permit a Swap Entity to rely on written representations to satisfy its due diligence obligations unless it has information that would cause a reasonable person to question the accuracy of the representations.[179] Additionally, two other commenters supported the reasonable person standard in 2011.[180] One commenter asserted that the reasonable person standard would help to ensure that SBS Entities are acting on reliable information because of the duty it would impose to verify the accuracy of a representation if the SBS Entity had some reason to question

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176 See FIA/ISDA/SIFMA, supra note 5; APPA, supra note 5; BlackRock, supra note 5; SIFMA (August 2011), supra note 5; ABC, supra note 5; ABA Committees, supra note 5; NABL, supra note 5.

177 See FIA/ISDA/SIFMA, supra note 5.

178 See NABL, supra note 5.

179 See SIFMA (August 2015), supra note 5.

180 See Better Markets (August 2011), supra note 5; CCMR, supra note 5. See also CFA, supra note 5 (opposing both proposed standards but noting a preference for the reasonable person standard over the actual knowledge standard).

it.[181] The commenter also argued that the reasonable person standard would be easier to monitor and enforce because it would be objective rather than subjective.[182]

Some commenters suggested that the Commission require detailed representations.[183] One commenter asked the Commission to clarify that, for purposes of "red flags," the knowledge test should apply only to individuals with knowledge of the security-based swap transaction; information that may be available to other parts of the SBS Entity organization should not be imputed to those individuals.[184] Another commenter requested that the Commission clarify that any representations made by a special entity or its representative to satisfy the rules do not give any party any additional rights, such as rescission or monetary compensation (e.g., if the representations turn out to be incorrect).[185] Additionally, the commenter asserted that an SBS Dealer should be permitted to rely on a single set of representations made by a special entity at the beginning of a trading relationship, rather than requiring the SBS Dealer to obtain a new representation with each transaction, if the special entity represents that it will notify the SBS Dealer when the representations become inaccurate.[186]

More generally, another commenter recommended allowing representations to be

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181 See Better Markets (August 2011), supra note 5.

182 Id.

183 See AFSCME, supra note 5 (recommending requiring written representations that are "sufficiently detailed and informative to permit reliance," and requiring SBS Entities to have a reasonable basis for believing the representations to be true); CFA, supra note 5 (recommending requiring that the written representations be sufficiently detailed to allow such an assessment).

184 See FIA/ISDA/SIFMA, supra note 5.

185 See ABC, supra note 5.

186 Id.

contained in counterparty relationship documentation if agreed to by the counterparties, and requiring counterparties to undertake to update such representations with any material changes.[187] The commenter also suggested that an SBS Entity that is also registered with the CFTC as a Swap Entity should be permitted to rely on a counterparty's written representations with respect to the CFTC's business conduct rules to satisfy its due diligence requirements under the Commission's business conduct rules provided that the SBS Entity provides notice of such reliance to the counterparty and the counterparty does not object.[188] The commenter argued that this would speed implementation and lower costs without reducing counterparty protections.[189] Finally, the commenter recommended including both a general reliance on representations provision and also specific reliance on representations safe harbors in the individual rules that specify what representations the SBS Entity should obtain to satisfy the safe harbor.[190]

3. Response to Comments and Final Rule

The Commission is adopting new Rule 15Fh-1(b), which provides that an SBS

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187 See SIFMA (August 2015), supra note 5.

188 Id. In a subsequent letter, the commenter explained that there is a multilateral protocol that has been adopted by most market participants as a means of complying with the CFTC rules. See SIFMA (November 2015), supra note 5. The commenter noted that the representations contained in this protocol only expressly address market participants' trading in swaps, but asserted that " the factual matters addressed by those representations typically do not vary as between trading in swaps and trading in [security-based swaps]. As a result, requiring SBS Entities to obtain separate representations specifically addressing [security-based swaps] would impose additional costs with few, if any, additional benefits." Id.

189 SIFMA (November 2015), supra note 5.

190 Id.

Entity may rely on written representations to satisfy its due diligence requirements under the business conduct rules unless it has information that would cause a reasonable person to question the accuracy of the representation. Under this standard, if an SBS Entity has in its possession information that would cause a reasonable person to question the accuracy of the representation, it will need to make further reasonable inquiry to verify the accuracy of the representation.[191]

We understand that this is a market in which parties rely heavily on representations both with respect to relationship documentation and the transactions themselves. While both standards we proposed for comment could be workable in this context, we recognize that neither provides the absolute certainty sought by some commenters. As we explained in the Proposing Release, 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.[192] Under an "actual knowledge" standard, however, an SBS Entity can rely on a representation unless it knows that the representation is inaccurate. This alternative could allow SBS Entities to rely on questionable representations insofar as they do not have actual knowledge that the representation is inaccurate, even if they have information that would cause reasonable

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191 See Proposing Release, 76 FR at 42404, supra note 3. As described infra in Section II.G.0, Rule 15Fh-3(e) will require an SBS Dealer to have policies and procedures reasonably designed to obtain and retain certain essential facts regarding a known counterparty. As a result, information in the SBS Entity's possession will include information gathered by an SBS Dealer through compliance with the "know your counterparty" provisions of 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.

192 See Proposing Release, 76 FR at 42404, supra note 3.

persons to question their accuracy. As a result, this alternative could potentially reduce the benefits of the verification of status, know your counterparty, suitability and special entity requirements and result in weaker protections for counterparties to SBS Entities. In contrast, the "reasonable person" standard under the rule as adopted should help ensure that SBS Entities do not disregard facts that call into question the validity of the representation.[193]

Further, this standard also is consistent with the standard adopted by the CFTC under which a Swap Entity cannot rely on a representation if the Swap Entity has information that would cause a reasonable person to question the accuracy of the representation.[194] This consistency will result in efficiencies for entities that have already established infrastructure to comply with the CFTC standard.

The rule as adopted would permit an SBS Entity to reasonably rely on the representations of a counterparty or its representative to satisfy its due diligence obligations under the business conduct rules, including Rules 15Fh-2(a) and (d), 15Fh-3(a), (e) and (f), 15Fh-4 and 15Fh-5. We are not requiring a specified level of detail for these representations but note that they should be detailed enough to permit the SBS

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193 Cf. Exchange Act Rule 3a71-3(4) (permitting reliance on a counterparty representation unless the party seeking to rely on the representation "knows or has reason to know that the representation is not accurate; . . . a person would have reason to know that the representation is not accurate if a reasonable person should know, under all of the facts of which the person is aware, that it is not accurate"). See also Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities; Final Rule; Republication, Exchange Act Release No. 72472 (Jun. 25, 2014), 79 FR 47277, 47313 (Aug. 12, 2014 (republication)) ("Cross-Border Adopting Release") (noting that "this 'known or have reason to know' standard should help ensure that potential [SBS Entities] do not disregard facts that call into question the validity of the representation").

194 See CFTC Adopting Release, 77 FR at 9749, supra note 21.

Entity to form a reasonable basis for believing that the applicable requirement is satisfied.[195]

Nothing in our rules would prohibit an arrangement under which the parties agree that representations will be provided in counterparty relationship documentation, and that they will update such representations with any material changes, as suggested by commenters.[196]

We are not accepting the commenter's suggestion that we provide that in every instance an SBS Entity that is also registered with the CFTC as a Swap Entity will be permitted to rely on a counterparty's pre-existing written representations with respect to the CFTC's business conduct rules to satisfy its due diligence requirements under the Commission's business conduct rules, provided that the SBS Entity provides notice of such reliance to the counterparty and the counterparty does not object.[197] Rule 15Fh-1(b) as adopted sets out the standard pursuant to which an SBS Entity can rely on representations to satisfy its due diligence obligations, and does not speak to the process

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195 See AFSCME, supra note 5 (recommending requiring written representations that are "sufficiently detailed and informative to permit reliance," and requiring SBS Entities to have a reasonable basis for believing the representations to be true); CFA, supra note 5 (recommending requiring that the written representations be sufficiently detailed to allow such an assessment).

196 See FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

197 Id. In a subsequent letter, the commenter explained that there is a multilateral protocol that has been adopted by most market participants as a means of complying with the CFTC rules. See SIFMA (November 2015), supra note 5. The commenter noted that the representations contained in this protocol only expressly address market participants' trading in swaps, but asserted that " the factual matters addressed by those representations typically do not vary as between trading in swaps and trading in [security-based swaps]. As a result, requiring SBS Entities to obtain separate representations specifically addressing [security-based swaps] would impose additional costs with few, if any, additional benefits." Id.

the SBS Entity will need to undertake to meet the standard. The question of whether reliance on the representations that had been obtained with respect to the CFTC business conduct rules, including the process by which the SBS Entity makes that determination, would satisfy an SBS Entity's obligations under our business conduct rules will depend on the facts and circumstances of the particular matter.[198]

We are not adopting the suggestion of one commenter that "the knowledge test should be applied only to individuals with knowledge of the SBS transaction."[199] In some instances it may be appropriate to look only to the knowledge of persons involved in a security-based swap transaction for purposes of determining whether an SBS Entity reasonably relied on representations. However, the determination whether to impute to the individuals that are involved in a securities-based swap transaction knowledge that may be available in other parts of the SBS Entity will depend on the facts and circumstances of the particular matter. At a minimum, an SBS Entity seeking to rely on representations cannot ignore information that would cause a reasonable person to question the accuracy of those representations.

E. Policies and Procedures Alternative

1. Proposal

The Commission solicited comment on whether an SBS Entity should be deemed to have complied with a requirement under the proposed rules if it has: (1) established and maintained written policies and procedures, and a documented system for applying

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198 See SIFMA (August 2015), supra note 5; SIFMA (November 2015), supra note 5.

199 See FIA/ISDA/SIFMA, supra note 5 (arguing that information that may be available to other parts of the SBS Entity organization should not be imputed to those individuals involved in the SBS transaction).

those policies and procedures, that are reasonably designed to achieve compliance with the requirement; and (2) 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.[200]

2. Comments on the Proposal

One commenter addressed the policies and procedures alternative.[201] The commenter opposed the alternative, arguing that it would reward the process of achieving compliance more than actually achieving compliance.[202] However, the commenter asserted that SBS Entities should be required to establish, maintain, document and enforce appropriate policies and procedures, and that the Commission should take them into account when determining the sanctions for violations.[203] The commenter argued that the requirement regarding policies and procedures should supplement the requirements or prohibitions in the rules, not supplant them.[204]

3. Response to Comments and Final Rule

After taking into consideration the comment, the Commission is not adopting a general policies and procedures safe harbor. The Commission acknowledges the importance of policies and procedures as a tool to achieving compliance with applicable regulatory and other requirements but agrees with the commenter that a general policies

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200 See Proposing Release, 76 FR at 42402, supra note 3.

201 See CFA, supra note 5.

202 Id.

203 Id.

204 Id.

and procedures safe harbor could have the unintended effect of rewarding the process towards achieving compliance more than the result of actually achieving compliance.[205]

As discussed more fully herein, Rule 15Fh-3(h) requires that an SBS Entity establish, maintain and enforce written policies and procedures that are reasonably designed to prevent violations of applicable securities laws, and rules and regulations thereunder. Rule 15Fh-3(h) also provides an affirmative defense to a charge of failure to supervise diligently based, in part, on the establishment and maintenance of these policies and procedures, where the 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. In addition, consistent with the approach of the CFTC, we are providing targeted representations-based safe harbors,[206] which should result in efficiencies for entities that have already established infrastructure to comply with the CFTC rules.

F. Definitions

1. Proposed Rule

Proposed Rules 15Fh-2(a), (c), (e) and (f), which would define "act as an advisor to a special entity," "independent representative of a special entity," "special entity," and

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205 See CFA, supra note 5.

206 See, e.g., Rule 15Fh-3(f)(3), discussed in Section II.G.3, infra, under which an SBS Dealer can generally satisfy its obligations by obtaining representations with respect to certain suitability requirements, and Rule 15Fh-5(b), discussed in Section II.H.6, infra, under which an SBS Entity can generally satisfy its obligations with respect to having a reasonable basis to believe that a special entity counterparty has a qualified independent representative.

"subject to a statutory disqualification," respectively are discussed in Section II.H below in the context of the special entity requirements.

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(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.

2. Comments on the Proposed Rule

a. Definitions Relating to the Rules Applicable to Dealings with Special Entities

Comments on paragraphs (a), (c), (e) and (f) of proposed Rule 15Fh-2 defining "act as an advisor," "independent representative of a special entity," "special entity" and "subject to a statutory disqualification," respectively are addressed below in Section II.H.

b. Eligible Contract Participant

One commenter addressed proposed Rule 15Fh-2(b) defining "eligible contract participant."[207] The commenter pointed out an error in the cross-reference in the rule to the Exchange Act definition and recommended adding a reference to applicable rules and interpretations of the Commission and the CFTC.[208]

c. SBS Dealer or Major SBS Participant

Three commenters addressed proposed Rule 15Fh-2(d) defining SBS Dealer or

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[207] See SIFMA (August 2015), supra note 5.

[208] Id.

Major SBS Participant.[209] Two commenters suggested that the Commission adopt a broader definition that would apply the business conduct rules to any person acting on behalf of the SBS Entity, including an associated person, consistent with the CFTC business conduct rules.[210] One commenter asserted that this would prevent SBS Entities from "evad[ing] the business conduct rules by doing through third parties what they would not be permitted to do directly."[211] The commenter also discouraged the Commission from seeking to identify all of the requirements that would apply to an associated person of an SBS Entity, suggesting that the rules should apply in any circumstance where an SBS Entity acts through or by means of an associated person or other party.[212]

A third commenter recommended that the Commission clarify that associated persons of an SBS Entity should only be directly responsible for complying with the disclosure rules and rules involving interactions with counterparties, and should not be responsible for complying with internal business conduct standards, such as the rules relating to supervision and requiring designation of a CCO.[213] The commenter also suggested that the Commission define "associated person" as "an associated person of an [SBS Dealer] or [Major SBS Participant] through whom the [SBS Dealer] or [Major SBS

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209 See CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

210 See CFA, supra note 5; SIFMA (August 2015), supra note 5.

211 See CFA, supra note 5.

212 Id.

213 See FIA/ISDA/SIFMA, supra note 5.

Participant] acts."[214]

3. Response to Comments and Final Rule

The Commission is moving the definition of "independent representative of a special entity" from Rule 15Fh-2 to Rule 15Fh-5 and accordingly, re-designating paragraphs (d) through (f) of Rule 15Fh-2 as paragraphs (c) through (e). The definition of "independent representative of a special entity" and paragraphs (a), (d) and (e) of Rule 15Fh-2 (defining "act as an advisor," "special entity" and "subject to a statutory disqualification," respectively) are addressed below in Section II.H.

The Commission is adopting Rule 15Fh-2(b) with two modifications. In response to a suggestion from a commenter,[215] the Commission is correcting a typographical error in the cross-reference to the Exchange Act definition of "eligible contract participant" in the proposed rule. The proposed rule referenced "Section 3(a)(66)" of the Exchange Act, but should have referenced Section 3(a)(65) of the Exchange Act, which defines an eligible contract participant. Section 3(a)(65) of the Exchange Act, in turn, provides that the term eligible contract participant "has the same meaning as in section 1a of the Commodity Exchange Act." We have also revised the definition in response to the same commenter's request that we add a reference to applicable rules and interpretations of the Commission and the CFTC to incorporate the joint SEC-CFTC rulemaking adopted in May 2012.[216] In this regard, we note that the Commission and the CFTC jointly further

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214 Id.

215 See SIFMA (August 2015), supra note **5**.

216 Section 712(d)(1)(A) of the Dodd-Frank Act provides, among other things, that the CFTC and the Commission, in consultation with the Board of Governors, shall further define the term "eligible contract participant." Pub. L. 111-203, 124 Stat. 1376 (2010). Moreover, Section 712(d)(4) provides that any interpretation of, or

defined the term eligible contract participant by adopting rules and regulations under the Commodity Exchange Act.[217] Thus, as adopted, the definition of "eligible contract participant" in Rule 15Fh-2(b) refers to: "any person as defined in Section 3(a)(65) of the Act and the rules and regulations thereunder and in Section 1a of the Commodity Exchange Act and the rules and regulations thereunder."

After considering the comments, the Commission is adopting Rule 15Fh-2(d) as proposed, re-designated as Rule 15Fh-2(c). The statute defines the term "associated person of a security-based swap dealer or major security-based swap participant" to include "any person directly or indirectly controlling, controlled by, or under common control with" an SBS Dealer or Major SBS Participant.[218] While the SBS Entity remains ultimately responsible for compliance with the business conduct standards, 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 applicable business conduct standards.

The Commission declines to modify the definition, as requested by some commenters, to apply to persons acting on behalf of the SBS Entity.[219] We believe it unnecessary to expand the definition because, as noted above, the SBS Entity remains

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guidance by either Commission regarding, a provision of Title VII of the Dodd Frank Act shall be effective only if issued jointly by the CFTC and the Commission, after consultation with the Board of Governors, if this title requires the Commissions to issue joint regulations to implement the provision. Id.

217 See Definitions Adopting Release, supra note 115.

218 Section 3(a)(70)(A)(ii) of the Exchange Act, 15 U.S.C. 78c(a)(70)(A)(ii).

219 See CFA, supra note 5; SIFMA (August 2015), supra note 5.

ultimately responsible for compliance with the business conduct standards, whether the SBS Entity is acting through, or by means of, an associated person or other person.

In response to the commenter that raised concerns that associated persons should not be responsible for complying with "internal" business conduct standards,[220] the Commission notes that Rule 15Fh-2(c) provides that the definition of an SBS Entity includes associated persons of the SBS Entity "where relevant." Certain rules, including the so-called "internal" business conduct rules (e.g., Rule 15Fh-3(h) (supervision) and Rule 15Fk-1 (designation of CCO)) may apply to some but not all associated persons of an SBS Entity, and the registrant remains ultimately responsible for compliance with all of the business conduct rules that are the subject of this rulemaking.

G. Business Conduct Requirements

1. Counterparty Status

a. Proposed Rule

Section 15F(h)(3)(A) of the Exchange Act directs that business conduct requirements adopted by the Commission shall establish a duty for an SBS Entity to verify that any counterparty meets the eligibility standards for an ECP.[221]

Proposed Rule 15Fh-3(a)(1) would require an SBS Entity 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

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220 See FIA/ISDA/SIFMA, supra note 5.

221 15 U.S.C. 78o-10(h)(3)(A).

or SEF.[222] Proposed Rule 15Fh-3(a)(2) would require an SBS Entity to verify whether a counterparty whose identity is known to the SBS Entity prior to the execution of the transaction is a special entity before entering into a security-based swap with that counterparty, no matter where the transaction is executed.[223]

b. Comments on the Proposed Rule

Three commenters addressed proposed Rule 15Fh-3(a).[224] One opposed limiting the application of the rule to known counterparties, noting that this would invite SBS Entities to promote anonymous off-exchange transactions that would allow them to avoid obligations otherwise owed to special entities.[225] The commenter asserted that the only exemption from the verification requirement should be for transactions on a registered exchange or SEF, and that for such transactions, if the SBS Entity knows the identity of the counterparty prior to the transaction and has reason to believe it may not be an ECP,

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222 Proposed Rule 15Fh-3(a)(1). See Section 6(l) of the Exchange Act (making it unlawful to effect a security-based swap transaction with or for a person that is not an ECP unless such transaction is effected on a registered national securities exchange). See also Section 5(e) of the Securities Act of 1933, 15 U.S.C. 77e(e)) ("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"). See also Registration and Regulation of Security-Based Swap Execution Facilities, Exchange Act Release No. 63825 (Feb. 2, 2011), 76 FR 10948 (Feb. 28, 2011) ("SEF Registration Proposing Release") (proposed Rule 809 would limit SEF participation to registered SBS Dealers, Major SBS Participants, brokers and ECPs).

223 Proposed Rule 15Fh-3(a)(2). See generally Section 15F(h)(1)(D) of the Exchange Act, 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").

224 See CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

225 See CFA, supra note 5.

the SBS Entity should be required to undertake an additional inquiry to verify the counterparty's status.[226] The commenter also recommended that verification take place before the SBS Entity offers to enter into a transaction, rather than before execution.[227]

Two commenters recommended that the exception for transactions on a registered exchange or SEF be broadened to apply to the verification of special entity status in addition to the verification of ECP status.[228] One commenter also recommended expanding the exception to include exempt SEFs, such as a foreign SEF that the Commission determines to be subject to a comparable home country regime.[229] Additionally, as part of a series of recommendations to harmonize with the CFTC's treatment of employee benefit plans defined in Section 3 of ERISA, the commenter suggested requiring an SBS Entity to verify whether a counterparty is eligible to elect to be a special entity, and if so, to notify such counterparty.[230]

The other commenter also recommended further narrowing the application of the rule by excluding transactions in which the identity of the counterparty is known just prior to execution, arguing that an SBS Entity would have insufficient time to exchange representations with the counterparty or otherwise verify the counterparty's status in

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226 Id. The commenter also recommended that the Commission conform to the CFTC's then-pending proposal, which would have required counterparty status verification in any transaction other than anonymous transactions on a swap execution facility. We note, however, that the CFTC subsequently adopted a rule that clarified that the exemption from verification applies to all transactions on a designated contract market ("DCM") and to anonymous transactions on a swap execution facility. See CFTC Adopting Release, 77 FR at 9757, supra note 21.

227 See CFA, supra note 5.

228 See FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

229 SIFMA (August 2015), supra note 5.

230 Id. See also discussion in Section III.H.1, infra.

those situations.[231] Alternatively, the commenter requested that the Commission require SEFs to adopt rules that would permit verification of the counterparty's status.[232] The commenter also opposed establishing specific documentation requirements regarding counterparty status, asserting that it would not allow for flexible risk management and investment decisions through private contractual negotiation.[233]

c. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-3(a) with certain modifications.

Rule 15Fh-3(a)(1), as adopted, requires an SBS Entity to verify the ECP status of a counterparty before entering into a security-based swap with that counterparty other than a transaction executed on a registered national securities exchange. We are not adopting the further provision of the proposed rule that would have limited the application of the verification requirement to a counterparty "whose identity is known to the SBS Entity prior to the execution of the transaction." We also are not adopting the provision of the proposed rule that would have provided that the verification requirement does not apply to transactions executed on a SEF. These changes reflect the Commission's further consideration of the regulatory framework provided by the Dodd-Frank Act.

In particular, 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

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231 FIA/ISDA/SIFMA, supra note 5.

232 Id.

233 Id.

transaction is effected on a registered national securities exchange.[234] Section 6(l) of the Exchange Act does not provide an exception for transactions effected on SEFs, or for transactions where the identity of a counterparty is not known to the SBS Entity prior to the execution of the transaction. Thus, upon further consideration of the proposed rule in the context of the statute, we are not providing an exception for transactions executed other than on a registered national securities exchange, and we are not limiting the requirement to known counterparties because Section 6(l) of the Exchange Act does not contain a similar exception or limitation, and we do not wish to suggest to SBS Entities that Section 6(l) is similarly limited. In this regard, we note that, even with these modifications, the scope of Section 6(l) of the Exchange Act ("unlawful to effect a transaction in a security-based swap") is broader than the activity covered by Rule 15Fh-3(a)(1) ("before entering into a security-based swap"), and that SBS Entities, and other market participants, have an independent obligation under Section 6(l) for any action covered by that section.[235]

As noted in the Proposing Release, an SBS Entity that has complied with the requirements of Rule 15Fh-3(a)(1) concerning a counterparty's eligibility to enter into a particular security-based swap fulfills its obligations under the rule for that security-based

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234 See Proposing Release, 76 FR at 42403, supra note 5. 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").

235 See also Section 5(e) of the Securities Act, 15 U.S.C. 77e(e) ("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"). This rulemaking does not address and has no applicability with respect to the requirements under the Securities Act applicable to security-based swap transactions.

swap, even if the counterparty subsequently ceases to meet the eligibility standards for an ECP during the term of that security-based swap.[236] However, an SBS Entity will need to verify the counterparty's status for any subsequent action covered by Rule 15Fh-3(a)(1), (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 renewed or "brought down" as of the date of the subsequent action covered by 15Fh-3(a)(1). In this manner, counterparties will be able to make representations about their status at the outset of a relationship, and can undertake to "bring down" that representation for each relevant action involving a security-based swap. In addition, as noted above, market participants have an independent obligation under Section 6(l) of the Exchange Act for any action covered by that section.

Rule 15Fh-3(a)(2), as adopted, requires an SBS Entity to verify whether a counterparty is a special entity before entering into a security-based swap transaction with that counterparty, unless the transaction is executed on a registered or exempt SEF or registered national securities exchange and the SBS Entity does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rule. The rule as proposed would have limited the verification of special entity status to counterparties whose identity is known to the SBS Entity prior to the execution of the security-based swap transaction. Because the question of special entity status figures most significantly in connection with the application of the special entity rules (Rules 15Fh-4, 15Fh-5 and

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236 See Proposing Release, 76 FR at 42404, supra note 5.

15Fh-6), we have modified the special entity verification rule to track the exceptions to those rules.[237] Accordingly, the verification of special entity status requirements will not apply where the transaction is executed on a registered or exempt SEF or registered national securities exchange, and the SBS Entity does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rule.

An SBS Entity that has complied with the requirements of Rule 15Fh-3(a)(2) concerning verification whether a counterparty is a special entity before entering into a particular security-based swap with that counterparty fulfills its obligations under the rule for that security-based swap.[238] However, an SBS Entity will need to verify the counterparty's status for any subsequent action covered by Rule 15Fh-3(a)(2) (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 renewed or "brought down" as of the date of the subsequent action covered by 15Fh-3(a)(2). In this manner, counterparties will be able to make representations about their status at the outset of a relationship, and can undertake to "bring down" that representation for each relevant action involving a security-based swap.

Additionally, the Commission is adding a new paragraph (a)(3), special entity election, which requires an SBS Entity, in verifying the special entity status of a counterparty pursuant to Rule 15Fh-3(a)(2), to verify whether a counterparty is eligible to

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237 See Section II.B.

238 See Proposing Release, 76 FR at 42404, supra note 5.

elect not to be a special entity as provided for in the adopted special entity definition in Rule 15Fh-2(d)(4), and if so, notify such counterparty. This change is intended to provide the greatest protections to the broadest categories of special entities, while still allowing them the flexibility to elect not to avail themselves of special entity protections.[239]

Although the Dodd-Frank Act does not specifically require an SBS Entity to verify whether a counterparty is a special entity or is eligible to elect not to be a special entity, the Commission believes that such verification will help to ensure the proper application of the business conduct rules that apply to SBS Entities dealing with special entities.[240]

The Commission is not revising the rule, as suggested by a commenter,[241] to require that verification of special entity counterparty status take place before an SBS Entity "offers" to enter into a transaction. We agree with the commenter that it is important for an SBS Entity to verify special entity status "as soon as possible . . . to ensure timely compliance with the other obligations that accompany transactions with these entities." As explained in Section II.A, when the rules refer to a "counterparty" of the SBS Entity, the term "counterparty" includes a potential counterparty where

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239 As explained in Section II.H.1, we are interpreting the definition of "special entity" to distinguish entities that are "defined in" section 3 of ERISA but not "subject to" regulation under Title I of ERISA. Our rules as adopted would include within the "special entity" definition entities such as church plans and plans maintained solely for the purpose of complying with applicable workmen's compensation laws, unemployment compensation, or disability insurance laws but allow them to elect not to be treated as "special entities."

240 See Section II.H, infra.

241 See CFA, supra note 5.

compliance with the obligation is required before the SBS Entity and the "counterparty" have actually entered into the security-based swap.

The Commission is not specifying the manner of documentation or procedures required for compliance with Rule 15Fh-3(a).[242] Among other things, an SBS Entity could rely on representations in accordance with Rule 15Fh-1(b). For example, an SBS Entity could verify that a counterparty is an ECP by obtaining a written representation from the counterparty as to specific facts about the counterparty (e.g., that it has $100 million in assets) to conclude that the counterparty is an ECP, unless the SBS Entity has information that would cause a reasonable person to question the accuracy of the representation. Similarly, an SBS Entity could seek to 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. The SBS Entity also could seek to obtain a representation in writing from the counterparty if it elects not to be a special entity, as provided for in the special entity definition in Rule 15Fh-2(d)(4). Consistent with Rule 15Fh-1(b), however, an SBS Entity cannot disregard information that would cause a reasonable person to question the accuracy of the representation.

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[242] See Proposing Release, 76 FR at 42403, supra note 3. The Commission separately has proposed rules regarding recordkeeping and reporting requirements for SBS Entities that would require an SBS Entity to keep records of its verification. See Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, Exchange Act Release No. 71958 (Apr. 17, 2014), 79 FR 25193, 25208 and 25217-25218 (May 2, 2014) ("Recordkeeping Release") (proposed Rules 18a-5(a)(17) and 18a-5(b)(13)).

2. Disclosure

Section 15F(h)(3)(B) of the Exchange Act broadly requires that business conduct requirements adopted by the Commission require 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.[243]

a. Disclosure not Required When the Counterparty is an SBS Entity or a Swap Entity

i. Proposed Rules

Section 15F(h)(3)(B) 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."[244] As explained in the Proposing Release, the Commission believes 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."[245] Accordingly, proposed Rule 15Fh-3(b) (information about material risks and characteristics, and material incentives or conflicts of interests), proposed Rule 15Fh-

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243 15 U.S.C. 78o-10(h)(3)(B).

244 15 U.S.C. 78o-10(h)(3)(B).

245 7 U.S.C. 6s(h)(3)(B). See Proposing Release, 76 FR at 42405, supra note 3.

3(c) (the daily mark), and proposed Rule 15Fh-3(d) (clearing rights) would not apply whenever the counterparty is an SBS Entity or Swap Entity.

ii. Comments on the Proposal

Two commenters submitted comments on the application of the disclosure requirements when the counterparty is an SBS Entity or Swap Entity.[246] One commenter asserted that the disclosure requirements should apply even when the counterparty is also an SBS Entity.[247] Another commenter agreed with the Commission's interpretation that Congress intended the exclusion to apply to transactions with other SBS Entities and Swap Entities.[248] However, in response to a specific request for comment, the commenter asserted that the Commission should not exempt transactions with other entities (such as banks or broker-dealers) from the disclosure requirements, or otherwise subject them to different disclosure standards, because while more sophisticated banks or brokers may benefit, less sophisticated parties would be left without adequate protections.[249]

Additionally, as discussed in Section II.B, a commenter advocated for adding exceptions to the disclosure requirements in Rules 15Fh-3(b) and (d) to cover security-based swaps that are intended to be cleared and that are either (1) executed on a registered national securities exchange or registered or exempt SEF and required to be cleared pursuant to Section 3C of the Exchange Act, or (2) anonymous.[250] The

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246 See Better Markets (August 2011), supra note 5; CFA, supra note 5.

247 See Better Markets (August 2011), supra note 5.

248 See CFA, supra note 5.

249 Id.

250 See SIFMA (August 2015), supra note 5.

commenter argued that this would harmonize the scope of the Commission's disclosure requirements with no-action relief provided by the CFTC with respect to its parallel requirements.[251]

iii. Response to Comments and Final Rules

After considering the comments, the Commission is adopting, as proposed, the exceptions from 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) for transactions in which the counterparty is an SBS Entity or Swap Entity. We are not adopting the suggestion that disclosure requirements apply even when the counterparty is an SBS Entity or Swap Entity. We believe that an SBS Entity would be well-positioned to negotiate with another SBS Entity, and nothing in our rules precludes an SBS Entity from requesting such disclosures.

In addition, the exceptions under the rules as adopted parallel the exceptions in the analogous CFTC rules. This consistency will result in efficiencies for entities that have already established infrastructure to comply with the CFTC standard.

For the reasons discussed in Section II.B, we are not providing additional exceptions for transactions that are intended to be cleared.[252]

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251 Id.

252 Id. See Swaps Intended to Be Cleared, CFTC Letter No. 13-70 (Nov. 15, 2013), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/13-70.pdf.

b. Timing and Manner of Certain Disclosures and Scope of Disclosure Rules

i. Proposed Rules

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 specific manner in which those disclosures are made as long as they are made "in a manner reasonably designed to allow the counterparty to assess" the information being provided.[253] Proposed Rule 15Fh-3(d) similarly would require that disclosures regarding certain clearing rights be made before entering into a security-based swap, but 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 written record of the non-written disclosures made pursuant to proposed Rules 15Fh-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 of the particular transaction.

ii. Comments on Proposed Rules

Timing and Manner of Certain Disclosures

Five commenters addressed the timing and manner of required disclosures.[254] One commenter recommended allowing disclosure requirements to be satisfied by the

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253 Section 15F(h)(3)(B) of the Exchange Act is silent regarding both form and timing of disclosure. See 15 U.S.C. 78o-10(h)(3)(B).

254 See ABC, supra note 5; CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; Better Markets (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

execution of a master agreement and provision of a trade acknowledgment.[255] Similarly, another commenter urged the Commission to permit all required disclosures to be made upfront at the beginning of a trading relationship, rather than on a transaction-by-transaction basis.[256]

Alternatively, if the Commission requires disclosure beyond the master agreement and trade acknowledgment, the first commenter encouraged the Commission to permit the use of standardized disclosures.[257] The commenter also recommended that the Commission not dictate the timing of required disclosures and permit SBS Entities to make required disclosures in advance, as opposed to immediately prior to the execution of a trade, so as not to interfere with the parties' desired timing.[258] However, the commenter noted that advance disclosure requirements would be infeasible for transactions executed on a SEF or exchange, or where the counterparty is known only immediately prior to or after execution.[259]

In contrast, two commenters advocated for more specific requirements with respect to the timing and manner of disclosure.[260] Both recommended that disclosure be required in writing and at a "reasonably sufficient time" prior to the execution of the transaction to allow counterparties to evaluate the information before deciding whether to

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255 See FIA/ISDA/SIFMA, supra note 5.

256 See ABC, supra note 5.

257 See FIA/ISDA/SIFMA, supra note 5.

258 Id.

259 Id.

260 See Better Markets (August 2011), supra note 5; CFA, supra note 5.

enter the transaction.[261] One commenter also asserted that disclosure should be in a clear and intelligible format that permits comparison between derivatives offered by different market participants.[262] The other commenter opposed allowing SBS Entities to satisfy disclosure requirements through entry into a master agreement and provision of a trade acknowledgement, arguing that key information could be lost in the fine print of legal documents.[263] At a minimum, if a master agreement is used, the commenter recommended that the required disclosures regarding material risks and characteristics and material incentives or conflicts of interest be provided in a clearly labeled, separate narrative incorporated into the overall document, and that all key issues be disclosed before the trade is executed and not in a post-trade acknowledgement.[264]

Another commenter also recommended that disclosure regarding material risks and characteristics and material incentives or conflicts of interest be required at a "reasonably sufficient time" prior to the execution of the transaction to harmonize with the CFTC's disclosure requirements.[265] Additionally, as discussed in Section II.B, the commenter advocated for adding exceptions to the disclosure requirements in Rules 15Fh-3(b) and (d) to cover security-based swaps that are intended to be cleared and that are either: (1) executed on a registered national securities exchange or registered or exempt SEF and required to be cleared pursuant to Section 3C of the Exchange Act, or

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261 See Better Markets (August 2011), supra note 5; CFA, supra note 5.

262 See Better Markets (August 2011), supra note 5.

263 See CFA, supra note 5.

264 Id.

265 See SIFMA (August 2015), supra note 5.

(2) anonymous.[266]

Written Records of Non-Written Disclosure

One commenter addressed the written record requirements in proposed Rules 15Fh-3(b)(3) and 15Fh-3(d)(3).[267] The commenter opposed permitting SBS Entities to make required disclosures orally, asserting that oral disclosure fails to promote pre-trade transparency and makes enforcement more difficult, and that SBS Entities may minimize disclosure of conflicts of interest when making them orally.[268] The commenter also argued that the Commission's approach to permitting oral disclosure "doesn't even have the benefit of saving labor, since the Commission proposes to require after-the-fact written disclosures of any information not made in writing prior to the transaction."[269]

Scope of Disclosure Rules

If the Commission requires disclosure beyond the master agreement and trade acknowledgment, one commenter encouraged the Commission to exclude from such requirements counterparties that are regulated entities such as banks, broker-dealers, and investment advisers.[270] Two other commenters argued that Major SBS Participants should not be subject to the disclosure requirements because they will be transacting with counterparties at arm's length.[271] Alternatively, one commenter suggested exempting transactions between Major SBS Participants and SBS Dealers from the disclosure

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266 Id.

267 See CFA, supra note 5.

268 See CFA, supra note 5.

269 Id.

270 See FIA/ISDA/SIFMA, supra note 5.

271 See BlackRock, supra note 5; MFA, supra note 5.

requirements, and allowing all other counterparties to opt out of certain disclosure requirements, in particular receiving written records of non-written disclosure.[272] Similarly, another commenter suggested that ECPs should have the option of opting-out of disclosures.[273]

iii. Response to Comments and Final Rules

After considering the comments, the Commission is adopting the rules substantially as proposed, with certain modifications. In response to commenters' concerns, the Commission is requiring that an SBS Entity make the disclosures required by Rule 15Fh-3(b) regarding material risks and characteristics and material incentives or conflicts of interest at a reasonably sufficient time prior to entering into a security-based swap to allow the counterparty to assess the disclosures. This will also be consistent with the CFTC's timing requirement for its parallel disclosures rules, resulting in efficiencies for entities that have already established infrastructure to comply with the CFTC standard.

With respect to the manner of disclosure, we are not adopting the commenters' suggestion that we impose more specific requirements with respect to the timing and manner of disclosure.[274] Instead, the Commission continues to believe it is appropriate to require only that 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 pursuant to Rule 15Fh-3(b). As

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272 See BlackRock, supra note 5.

273 See MFA, supra note 5.

274 See Better Markets (August 2011), supra note 5; CFA, supra note 5.

noted in the Proposing Release, 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, and 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.[275]

After considering the comments, the Commission is also adopting as proposed the requirements in Rules 15Fh-3(b)(3) and 15Fh-3(d)(3) that an SBS Entity make a written record of any non-written disclosures made pursuant to 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[276] of the particular transaction. As noted in the Proposing Release and suggested by commenters, the Commission understands 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.[277] The Commission believes that parties should have the flexibility to make disclosures by various means, including master agreements and related documentation, telephone calls, emails, instant

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275 See Proposing Release, 76 FR at 42406, supra note 3.

276 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).

277 See Proposing Release, 76 FR at 42406, supra note 3; FIA/ISDA/SIFMA, supra note 5.

messages, and electronic platforms.[278] Similarly, while we acknowledge the commenter's concern that SBS Entities may minimize disclosure of conflicts of interest when making them orally, we are not persuaded that requiring all disclosures be provided in writing prior to the parties' entering into a security-based swap would be necessary to provide protections under the rule as adopted. We further note that Rule 15Fh-3(b)(3), discussed in Section II.G.2.c, separately requires that an SBS Entity provide a written record of non-written disclosures no later than the delivery of the trade acknowledgement of the particular transaction. Accordingly, the Commission anticipates 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. While certain forms of disclosure may be highly standardized, certain provisions may need to be tailored to the particular transaction, most notably pricing and other transaction-specific commercial terms. As noted in the Proposing Release, the Commission believes this approach is generally consistent with the use of standardized disclosures suggested by industry groups and commenters.[279]

We do believe, however, that is it is important that the required disclosures be made at a reasonably sufficient time before the execution of the transaction to allow the counterparty to assess the disclosures. While this time may vary depending on the

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278 When SBS Entities rely on electronic media, their counterparties generally should 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 generally 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 F.R. 25843 (May 4, 2000).

279 See Proposing Release, 76 FR at 42406, supra note 3.

product and the counterparty, we do not believe, as suggested by some commenters, that SBS Entities should be able to rely on trade acknowledgements alone to satisfy certain disclosure requirements.[280] As noted in the Proposing Release, however, SBS Entities could rely on trade acknowledgements to memorialize non-written disclosures they made prior to entering into the proposed transaction.[281]

As discussed in Section II.B above, the Commission is limiting the disclosure requirements in Rules 15Fh-3(b) and (d) to circumstances where the identity of the counterparty is known to the SBS Entity at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rule. The disclosure requirements in Rules 15Fh-3(b) and (d) will not apply where the identity of the counterparty is not discovered until after the execution of the transaction, or where the SBS Entity learns the identity of the counterparty with insufficient time to be able to provide the necessary disclosures to satisfy its obligations under the rule without disrupting or delaying the execution of the transaction. Similarly, for the reasons discussed in Section II.A.3.d, we are not providing additional exceptions or "opt-out" rights.

Finally, we are not adopting the suggestion of one commenter that the Commission exclude from the disclosure requirements transactions with counterparties that are regulated entities such as banks, broker-dealers, and investment advisers.[282] Because information asymmetries exist in a market for opaque and complex products,

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280 See FIA/ISDA/SIFMA, supra note 5.

281 See Proposing Release, 76 FR at 42406, supra note 3.

282 See FIA/ISDA/SIFMA, supra note 5.

even for regulated entities, such disclosures may help inform counterparties concerning the valuations and material risks and characteristics of security-based swaps in the sometimes rapidly changing market environment.[283] In this regard, the external business conduct requirements promulgated under Section 15F(h) are intended to provide certain protections for counterparties, including information regarding the material risks and characteristics of the security-based swap, any material incentives or conflicts of interest that the SBS Entity may have, and the daily mark of the security-based swap. We believe the rules we are adopting today appropriately apply those requirements so that counterparties receive the benefit of those protections, and so are not providing counterparty exclusions beyond the exception for transactions with SBS Entities and Swap Entities discussed in Section II.G.2.a, infra.

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

i. Proposed Rule

Proposed Rule 15Fh-3(b)(1) would require an SBS Entity to disclose 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 would experience under specified circumstances. In the Proposing

[283] See Section VI.C, infra.

Release, the Commission also solicited comment regarding whether SBS Entities should be specifically required to provide scenario analysis disclosure.[284]

ii. Comments on the Proposed Rule

General

Seven commenters addressed the disclosure of material risks and characteristics of security-based swaps.[285] One commenter expressed support for the proposed disclosure requirements, agreeing that the disclosure should include any information for which there is a substantial likelihood that a reasonable investor would consider the information to be important in making an investment decision.[286]

Two commenters argued that the Commission should adopt different or modified disclosure requirements.[287] One commenter requested that the Commission clarify in the rule that: (1) the rule only requires disclosure about the material risks and characteristics of the security-based swap itself and not with respect to the underlying reference security or index, and (2) the rule does not require disclosure in relation to any particular counterparty.[288] The commenter also asked the Commission to eliminate the proposed requirement that risk disclosures set forth the approximate magnitude of the gains or losses the security-based swap will experience under specified circumstances because this is the functional equivalent of a requirement to provide a scenario analysis, which the

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284 See Proposing Release, 76 FR at 42409, supra note 3.

285 See Barnard, supra note 5; Better Markets (August 2011), supra note 5; CFA, supra note 5; Levin, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

286 See Barnard, supra note 5.

287 See FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

288 See FIA/ISDA/SIFMA, supra note 5.

commenter does not support (discussed below).[289] Additionally, the commenter noted its view that the Commission should not require an SBS Entity to disclose the absence of certain material provisions typically contained in master agreements for security-based swap transactions because master agreements differ and what is "typical" is not clear.[290] A second commenter requested a clarification that only material information is required to be disclosed.[291]

Three commenters argued for additional or modified requirements.[292] One asserted that the proposed disclosure obligations are too limited in terms of scope, form, and content.[293] The commenter suggested that the disclosure provisions should require "more complete, timely, and intelligible disclosure of all the risks, costs, and other material information relating to [security-based swap] transactions," including disaggregated prices and risks, listed hedge equivalents, scenario analysis (discussed below), and embedded financing costs.[294] Similarly, another commenter requested clarification regarding what material risks and characteristics must be disclosed, arguing that the disclosure should include liquidity risks, the details of (and separate prices for) the standardized component parts of any customized security-based swap, any features of the security-based swap that could disadvantage the counterparty (such as differences in interest rates paid versus those received), and where credit arrangements are built into

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289 Id.

290 Id.

291 See SIFMA (August 2015), supra note 5.

292 See Better Markets (August 2011), supra note 5; CFA, supra note 5; Levin, supra note 5.

293 See Better Markets (August 2011), supra note 5.

294 Id.

security-based swaps through forbearance of collateral posting, the embedded credit and its price.[295] A third commenter also suggested that the Commission clarify what material risks and characteristics must be disclosed, proposing that SBS Entities be required to disclose any material risk related to the source of a security-based swap's assets and any negative view by the SBS Entity itself of the assets' riskiness.[296] The commenter also recommended that SBS Entities be required to disclose the material risks and characteristics not just of the security-based swap itself, but also of any reference securities, indices, or other assets, noting that this disclosure would be particularly important when the security-based swap references unique pools of assets arranged by the SBS Entity.[297]

Another commenter, writing after the CFTC adopted its final rules, recommended that the Commission harmonize with the CFTC's requirement to disclose material risks and characteristics.[298] Specifically, the commenter requested that, like the CFTC, the Commission describe the material risks and characteristics to be disclosed as including "market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks," and "the material economic terms of the security-based swap, the terms relating to the operation of the security-based swap, and the rights and obligations of the parties during the term of the security-based swap."[299] The commenter argued that harmonization with the CFTC would help support the continued development of standard

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295 See CFA, supra note 5.

296 See Levin, supra note 5.

297 Id.

298 See SIFMA (August 2015), supra note 5.

299 Id.

disclosures, reducing compliance costs and preventing undue delays in execution, and would reduce the likelihood of inconsistent disclosures for similar products and resulting counterparty confusion.[300]

Scenario Analysis

We sought comment on whether we should require scenario analysis and, if so, what standards should apply. Eight commenters addressed the disclosure of scenario analysis.[301] Four commenters supported requiring scenario analysis disclosure to some degree.[302] Of these commenters, one suggested that the analysis include specific information about the security-based swap's liquidity and volatility.[303] Another recommended only requiring scenario analysis disclosure for "high-risk complex security-based swaps," and suggested that the Commission provide additional clarification or a definition for determining what security-based swaps are high-risk and complex.[304] A third commenter advocated requiring SBS Entities to notify counterparties of their right to receive a scenario analysis and to provide a scenario analysis at the request of a non-SBS Entity counterparty.[305] To reduce the costs associated with providing scenario analyses and to mitigate the disclosure of SBS Entities' proprietary

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300 Id.

301 See Barnard, supra note 5; Better Markets (August 2011), supra note 5; CFA, supra note 5; Markit, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2011), supra note 5; MFA, supra note 5; SIFMA (August 2015), supra note 5.

302 See Barnard, supra note 5; Better Markets (August 2011), supra note 5; CFA, supra note 5; Markit, supra note 5.

303 See Better Markets (August 2011), supra note 5.

304 See Barnard, supra note 5.

305 See Markit, supra note 5.

information, the commenter suggested that the Commission permit SBS Entities to delegate the provision of scenario analyses to qualified third-parties.[306] The commenter explained that requiring scenario analysis disclosure on a transaction-by-transaction basis would not be necessary because SBS Entity counterparties are generally sophisticated enough to create their own, more meaningful, portfolio-based analyses, but that scenario analyses could help a less sophisticated counterparty understand the dynamics and potential exposure of security-based swaps on a portfolio-level.[307] The commenter also noted that the Commission should encourage all market participants to create or obtain a portfolio-level scenario analysis, in keeping with industry best practices.[308]

Four commenters opposed requiring disclosure of scenario analysis.[309] One noted that requiring scenario analysis disclosure would have potentially significant adverse consequences for special entities and other counterparties, and urged the Commission to refrain from requiring it.[310] Specifically, the commenter explained that requiring scenario analysis would likely delay execution of transactions and expose counterparties to market risk for potentially extended periods of time (including at critical times when the counterparty is seeking to hedge its positions in volatile markets) because the development of scenario analyses depends upon the specific terms agreed by the parties and therefore, cannot be performed until full agreement on the material terms is

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306 Id.

307 Id.

308 Id.

309 See FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2011), supra note 5; MFA, supra note 5; SIFMA (August 2015), supra note 5.

310 See SIFMA (August 2011), supra note 5.

reached.[311] Additionally, the commenter noted that the development of such analyses would cause SBS Entities to incur substantial costs, which ultimately would be passed on to counterparties.[312] Another commenter opposed a requirement to provide scenario analysis and asserted that, if a scenario analysis is required, it should only be at the request of the counterparty and only with respect to scenarios based on parameters selected by the counterparty.[313] The commenter also expressed concern that providing a scenario analysis could be viewed as a "recommendation" that triggers other requirements under the proposed rules (e.g., suitability requirements).[314]

A third commenter, writing after the CFTC adopted final rules,[315] stated that, in its experience, the CFTC's scenario analysis requirement has complicated the ability of SBS Dealers to provide different pricing scenarios, either voluntarily or at the request of a counterparty, because it creates "uncertainty as to when those scenarios must satisfy the requirements for scenario analysis set forth in the CFTC EBC rules."[316]

A fourth commenter recommended that, to the extent a Major SBS Participant is transacting with an ECP at arm's-length, the Commission should explicitly exclude

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311 Id.

312 Id.

313 See FIA/ISDA/SIFMA, supra note 5.

314 Id.

315 The CFTC had proposed to require scenario analysis for "high-risk complex bilateral swaps" but in its final rules determined instead to require scenario analysis only when requested by the counterparty for any swap not "made available for trading" on a designated contract market or swap execution facility. To comply with the CFTC rule, swap dealers must disclose to counterparties their right to receive scenario analysis and consult with counterparties regarding design. See CFTC Adopting Release, 77 FR at 9762-9763, supra note 21. See also 17 CFR 23.431(b).

316 See SIFMA (August 2015), supra note 5.

scenario analysis from the information that the Major SBS Participant is required to disclose pursuant to Rule 15Fh-3(b).[317] The commenter asserted that scenario analysis disclosure would be costly and redundant since the rule would already require Major SBS Participants to undertake a transaction-specific analysis, and prepare tailored disclosures of a transaction's loss sensitivities to market factors and conditions, and the magnitude of gains and losses the transaction may experience under specified circumstances.[318]

iii. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-3(b)(1) with some modifications requested by commenters to more closely align the requirements of our rules with those of the CFTC.

We have revised the descriptions in Rule 15Fh-3(b)(1) of the required disclosures of material risks and characteristics of a security-based swap to harmonize with the descriptions in the parallel CFTC disclosure requirement. As adopted, Rule 15Fh-3(b)(1) requires an SBS Entity to disclose material information in a manner reasonably designed to allow the counterparty to assess the material risks and characteristics of the particular security-based swap, which may include (1) market risk,[319] credit risk,[320] liquidity risk,[321]

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317 See MFA, supra note 5.

318 Id.

319 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 Proposing Release, 76 FR at 42408 n.82, supra note 3.

320 By "credit risk," we mean the risk that a counterparty to a security-based swap "will fail to perform on an obligation" under the security-based swap. See Proposing Release, 76 FR at 42408 n.80, supra note 3.

321 By "liquidity risk," we mean the risk that a counterparty to a security-based swap "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

foreign currency risk, legal risk,[322] operational risk[323] and any other applicable risks, and (2) the material economic terms of the security-based swap, and the rights and obligations of the parties during the term of the security-based swap. These changes are intended to provide an illustrative list of material risks and characteristics. In addition, these changes will harmonize our rule with the requirements of the CFTC rule, which should result in efficiencies for SBS Entities that have already established infrastructure to comply with the CFTC rules, while still achieving the objectives of the rule to provide information to a counterparty to help them assess whether, and under what terms, they want to enter into the transaction.

The rule as adopted requires disclosure of "material" information regarding material risks and characteristics and material incentives or conflicts of interests. We believe that this modification will provide for an appropriate level of disclosure by requiring disclosure of "material" information, that is, the information most relevant to a counterparty's assessment of whether and under what terms to enter into a security-based swap. In addition, it will harmonize with the CFTC approach, promoting regulatory consistency across the swap and security-based swap markets, particularly among entities that transact in both markets and have already established infrastructure to comply with existing CFTC regulations. In response to comment, the Commission believes that for

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disruptions in the marketplace." See Proposing Release, 76 FR at 42408 n.83, supra note 3.

322 By "legal risk," we mean the risk that agreements are unenforceable or incorrectly or inadequately documented. See Proposing Release, 76 FR at 42408 n.85, supra note 3.

323 By "operational risk," we mean the risk that "deficiencies in information systems or internal controls, [including human error,] will result in unexpected loss." See Proposing Release, 76 FR at 42408 n.84, supra note 3.

purposes of evaluating the material risks and characteristics of the particular security-based swap, including its economic terms, material information about the referenced security, index, asset or issuer should be disclosed.[324] As one commenter suggested, this disclosure would be particularly important when, for example, the security-based swap references unique pools of assets arranged by the SBS Entity.[325]

The Commission anticipates that SBS Entities may provide these disclosures through various means, including by providing a scenario analysis, as noted in the Proposing Release.[326] We are not, however, adopting any requirements that would require an SBS Entity to provide scenario analysis. Although scenario analysis may prove a valuable analytic tool, it is one means by which information may be conveyed, and we acknowledge the concerns of commenters that a scenario analysis may not be necessary or appropriate in every situation to ensure that appropriate disclosures are made. We note, however, that nothing in our rules would preclude parties from requesting such analysis, even if a security-based swap is "made available for trading." In this regard, our approach differs from that of the CFTC which requires a Swap Dealer to provide scenario analysis when requested by a counterparty for any swap that is not "made available for trading" on a designated contract market or swap execution facility. We believe, however, that the approaches are consistent because, as noted above, the

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324 The manner in which and extent of information about the referenced security, index, asset or issuer is disclosed would depend on the particular facts and circumstances, including the public availability of the information.

325 See Levin, supra note 5.

326 See Proposing Release, 76 FR at 42408 n.88, supra note 3.

Commission is not prohibiting counterparties from requesting scenario analysis disclosure.

As noted in the Proposing Release, these disclosures are intended to pertain to the material risks and characteristics of the security-based swap, and not the material risks and characteristics of the security-based swap with respect to a particular counterparty.[327]

d. Material Incentives or Conflicts of Interest

i. Proposed Rule

Proposed Rule 15Fh-3(b)(2) would require the SBS Entity to disclose any material incentives or conflicts of interest that it 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.[328] We explained in the Proposing Release that we preliminarily believed 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

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[327] See Proposing Release, 76 FR at 42408 n.87, supra note 3. However, if an SBS Dealer recommends a security-based swap or trading strategy involving a security-based swap, or acts as an advisor to a special entity, for example, Rules 15Fh-3(f) and 15Fh-4, respectively, impose certain counterparty-specific requirements. See Rules 15Fh-3(f) and 15Fh-4, discussed infra in Sections II.G.0 and II.H.3.

[328] See Section 15F(h)(3)(B)(ii) of the Exchange Act, 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).

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 example, expected cash flows received from a transaction to hedge the security-based swap or that the security-based swap is intended to hedge.[329]

ii. Comments on the Proposed Rule

Seven commenters addressed the disclosure of material incentives or conflicts of interest.[330] One commenter expressed strong support for the proposed rule.[331] A second commenter also supported the proposed rule, noting that it is consistent with the CFTC's parallel requirement, except for the CFTC's requirement to disclose a pre-trade mid-market mark, which the commenter argued is of limited benefit and delays execution of transactions.[332] Three other commenters expressed support for the proposed rule but also suggested certain revisions to the rule.[333] One recommended modifying the rule to include specific disclosures by SBS Entities of any affiliations or material business relationships they may have with any provider of security-based swap valuation services.[334] Another noted that an SBS Entity's biggest conflict of interest would likely be the difference in compensation between selling a security-based swap (and in

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329 See Proposing Release, 76 FR at 42409, supra note 3.

330 See Barnard, supra note 5; IDC, supra note 5; CFA, supra note 5; Levin, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

331 See Barnard, supra note 5.

332 See SIFMA (August 2015), supra note 5.

333 See IDC, supra note 5; CFA, supra note 5; Levin, supra note 5.

334 See IDC, supra note 5.

particular, a customized security-based swap) versus another product with similar economic terms.[335] Accordingly, the commenter recommended that SBS Entities be required to include any differential compensation in their disclosure.[336] Additionally, the commenter asserted that if an SBS Entity is entering a trade as part of a trading strategy to move a position off its books, the SBS Entity should be required to disclose that particular conflict of interest and that the security-based swap is recommended to effect that strategy.[337] A third commenter suggested coordinating the proposed rule with the conflict of interest prohibitions in Sections 619 and 621 of the Dodd-Frank Act to clarify that those prohibitions cannot be circumvented through application of the business conduct disclosure requirements.[338] The commenter also recommended including in these required disclosures any otherwise hidden profits or returns that the SBS Entity expects to make from a security-based swap, related agreement or arrangement, or related hedging or trading activity.[339]

One commenter objected to any requirement that an SBS Entity disclose its anticipated profit for the security-based swap.[340] The commenter asserted that the best protection for a counterparty is reviewing and selecting the best available pricing.[341]

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335 See CFA, supra note 5.

336 Id.

337 Id.

338 See Levin, supra note 5.

339 Id.

340 See FIA/ISDA/SIFMA, supra note 5.

341 Id.

iii. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-3(b)(2) as proposed.

As noted in the Proposing Release, the Commission believes 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.[342] Accordingly, the disclosure required pursuant to Rule 15Fh-3(b)(2) generally should include information concerning any compensation (for example, 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 will not include, for example, expected cash flows received from a transaction to hedge the security-based swap or that the security-based swap is intended to hedge.

As discussed above, whether a conflict or incentive is material depends on the facts and circumstances of the particular matter. Although we are not expressly requiring disclosure of differential compensation as requested by the commenter, the difference in compensation an SBS Entity may receive for selling a security-based swap versus another product with similar economic terms may create a material incentive or conflict of interest that would need to be disclosed under the framework discussed above. Similarly, an SBS Entity would need to disclose material information concerning affiliations or

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[342] See Proposing Release, 76 FR at 42409, supra note 3.

material business relationships it may have with any provider of security-based swap valuation providers if those relationships create a material incentive or conflict of interest. Regarding the commenter's concern that the conflict of interest prohibitions in Sections 619 and 621 of the Dodd-Frank Act might be circumvented through application of the business conduct disclosure requirements,[343] nothing in our rules limits or restricts the applicability of other relevant laws.[344]

e. Daily Mark

Exchange Act Section 15F(h)(3)(B)(iii) directs that business conduct requirements adopted by the Commission require an SBS Entity to disclose to a counterparty (other than to another SBS Entity or Swap Entity): (i) for cleared security-based swaps, upon request of the counterparty, the daily mark from the appropriate derivatives clearing organization;[345] and (ii) for uncleared security-based swaps, the daily

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343 See Levin, supra note 5.

344 For instance, depending on the facts and circumstances, failure to disclose material conflicts of interest when there is a recommendation by a broker-dealer can be a violation of the antifraud rules. See, e.g., Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1172 (2d Cir. 1970) (explaining that failure to inform a customer fully of a possible conflict of interest in the securities which the broker recommended for purchase was an omission of material fact in violation of Rule 10b-5). See also In the Matter of Richmark Capital Corp., Exchange Act Release No. 48758 (Nov. 7, 2003) (Commission opinion) ("When a securities dealer recommends stock to a customer, it is not only obligated to avoid affirmative misstatements, but also must disclose material adverse facts of which it is aware. That includes disclosure of 'adverse interests' such as 'economic self-interest' that could have influenced its recommendation.") (citations omitted).

345 As noted in the Proposing Release, 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 Proposing Release, 76 FR at 42410 n.98, supra note 3; Section 17A(g) of the Exchange Act, 15 U.S.C. 78q-1(g).

mark of the transaction.

i. Proposed Rule

Proposed Rule 15Fh-3(c) would require an SBS Entity to disclose to its counterparty (other than to another SBS Entity or Swap Entity): (1) for a cleared security-based swap, upon the request of the counterparty, the daily end-of-day settlement price that the SBS Entity 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 to a different time, on each business day during the term of the security-based swap. Proposed Rule 15Fh-3(c)(2) would specify that the daily mark for an uncleared security-based swap may be based on market quotations for comparable security-based swaps, mathematical models or a combination thereof. Proposed Rule 15Fh-3(c)(2) also would require disclosure of the data sources and a description of the methodology and assumptions used to prepare the daily mark for an uncleared security-based swap, as well as any material changes to such data sources, methodology or assumptions during the term of the security-based swap.

ii. Comments on Proposed Rule

Ten comment letters addressed the requirement for SBS Entities to provide a daily mark.[346]

One commenter suggested modifications to the daily mark requirement to

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[346] See Barnard, supra note 5; Levin, supra note 5; IDC, supra note 5; AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5; FIA/ISDA/SIFMA, supra note 5; MFA, supra note 5; BlackRock, supra note 5; SIFMA (August 2011); SIFMA (August 2015), supra note 5.

harmonize with the CFTC's parallel requirement.[347] Specifically, for cleared security-based swaps, the commenter recommended that an SBS Entity simply be required to notify a counterparty of its right to receive the daily mark from the appropriate clearing agency upon request.[348] The commenter also argued that the CFTC's description of the clearinghouse's mark is less prescriptive.[349] Additionally, the commenter recommended that the Commission provide guidance clarifying that an SBS Entity will be deemed to satisfy the daily mark requirement for cleared security-based swaps if the counterparty has agreed to receive its daily mark from its clearing member.[350]

One commenter asserted that requiring SBS Entities to provide daily marks would not further the goal of providing helpful transparency because in most transactions marks are typically either based on internal models or derived from indices with which the transactions are not perfectly matched.[351] Another commenter asked the Commission to carefully review and consider the costs of such a requirement before imposing any obligation to provide daily marks, other than those agreed upon for collateral purposes or for which midmarket quotations are observable.[352] The commenter also requested that "sophisticated counterparties" be permitted to opt out of this requirement, and recommended that the Commission clarify that where parties have agreed upon a basis for margining uncleared security-based swaps, providing the daily mark used to make the

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347 See SIFMA (August 2015), supra note 5.

348 Id.

349 Id.

350 Id.

351 See AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5.

352 See FIA/ISDA/SIFMA, supra note 5.

related margin calculation should satisfy the SBS Entity's daily mark disclosure obligations.[353]

One commenter suggested that the data sources, methodology and assumptions used to prepare the daily mark should be required to constitute a complete and independently verifiable methodology for valuing each security-based swap entered into between the parties, noting that this would promote objectivity and transparency, and aid in the resolution of disputes.[354] In this regard, a second commenter also expressed support for requiring the provision of a daily mark and specifically for requiring disclosure of any material changes to the data sources, methodology and assumptions used to prepare the daily mark, noting that this should include disclosing if the data sources become unreliable or unavailable and any resulting changes to the valuations.[355]

A third commenter recommended requiring disclosure as to how the daily mark is calculated, including such information as whether the daily mark was calculated based on inputs related to actual trade activity, using mathematical models, quotes and prices of other comparable securities, and whether those inputs came from third-party valuation service providers.[356] The commenter added, however, that the proposed disclosure of the data sources and the description of the methodology and assumptions used were not likely to require the disclosure of proprietary information and that a general description of key valuation inputs should be sufficient.[357] Likewise, another commenter also

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353 Id.

354 See Barnard, supra note 5.

355 See Levin, supra note 5.

356 See IDC, supra note 5.

357 Id.

recommended that the Commission clarify in rule text that an SBS Entity is not required to disclose confidential, proprietary information about any model it may use to prepare the daily mark.[358]

This commenter also recommended that an SBS Entity should disclose additional information concerning its daily mark to ensure a fair and balanced communication, including that: (1) the daily mark may not necessarily be a price at which the SBS Entity or counterparty would agree to replace or terminate the security-based swap; (2) calls for margin may be based on considerations other than the daily mark; and (3) the daily mark may not necessarily be the value of the security-based swap that is marked on the books of the SBS Entity.[359] Additionally, this commenter advocated for eliminating the proposed requirement for the SBS Entity to disclose its data sources used to prepare the daily mark to harmonize more closely with the CFTC rule, which requires disclosure of assumptions and methodologies but not data sources.[360]

One commenter noted that Major SBS Participants, unlike SBS Dealers, will not always have access to sufficient market information to provide a daily mark, particularly if the security-based swap is not actively traded or if there are no current bid and offer quotes.[361] The commenter expressed concern that this could cause Major SBS Participants to have to reveal proprietary information about their trading book positions, particularly when providing the methodology and inputs that they used to prepare the

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358 See SIFMA (August 2015), supra note 5.

359 Id.

360 Id.

361 See MFA, supra note 5.

daily mark.[362] The commenter suggested permitting sophisticated counterparties to opt out of receiving daily marks.[363] Another commenter suggested either not requiring Major SBS Participants to provide the daily mark to its counterparties or in the alternative, to exempt transactions between Major SBS Participants and SBS Dealers and allow all other counterparties to opt out of receiving such disclosures.[364]

Several commenters raised potential conflicts of interest concerns in connection with providing the daily mark for uncleared security-based swaps. Two commenters recommended requiring SBS Entities to use third-party quotations whenever possible to calculate the daily mark for uncleared security-based swaps.[365] One commenter suggested allowing use of the midpoint between an SBS Entity's bid and offer prices only when the SBS Entity's internal book value falls within the same price range.[366] Additionally, this commenter suggested that the Commission consider requiring the SBS Entity to provide clients with actionable quotes or prices at which the SBS Entity would terminate the swap or allow the client to buy more, and with actionable quotes at a significant size as a means to ensure accuracy.[367] Another commenter noted its view that defining the daily mark for uncleared security-based swaps as the midpoint between the bid and offer prices, or the calculated equivalent thereof, could be problematic because it may present a conflict of interest for SBS Entities, particularly when the security-based

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362 Id.

363 Id.

364 See BlackRock, supra note 5.

365 See Levin, supra note 5; and IDC, supra note 5.

366 See Levin, supra note 5.

367 Id.

swaps are not actively traded or do not have consistent or up-to-date bid and offer quotes.[368] This commenter also suggested requiring SBS Entities and their counterparties to have a clearly defined process for resolving any potential valuation disputes. [369]

Two commenters addressed the communication of daily marks, supporting the use of web-based methods of communication.[370] One commenter advocated for web-based systems to be the preferred method of communication, but noted that since some market participants prefer more traditional methods of communication, web-based systems should not be required.[371] The commenter recommended requiring SBS Entities to have policies and procedures in place that reasonably ensure that any non-electronic means of communication is safe and secure and is otherwise comparable to web-based systems.[372] Additionally, the commenter generally requested that the Commission provide greater clarity on permissible methods for delivering daily mark disclosures, establish minimum requirements for the communication of daily marks (for instance, that the interfaces used provide counterparties with appropriate tools to initiate, track and close valuation disputes), and require SBS Entities to ensure that the method of communication is designed to protect the confidentiality of the data and prevent any unintentional or fraudulent addition, modification or deletion of a valuation record.[373] The second commenter suggested that the use of a secure website or electronic platform should be

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368 See IDC, supra note 5.

369 See IDC, supra note 5.

370 See Markit, supra note 5; IDC, supra note 5.

371 See Markit, supra note 5.

372 Id.

373 Id.

required to enhance data security.[374] The commenter noted that such a platform could also be used to provide transparency into the inputs used to determine the daily mark and to initiate inquiries or challenges to the daily mark.[375] The commenter also recommended that the Commission require daily mark information to be provided without charge.[376]

iii. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-3(c) as proposed, with modifications.

Cleared Security-Based Swaps

In response to concerns raised by a commenter,[377] the Commission is modifying the requirement in Rule 15Fh-3(c)(1) concerning delivery of the daily mark for cleared security-based swaps. For cleared security-based swaps, the proposed rule would have required the SBS Entity upon the request of the counterparty to provide the counterparty with the end-of-day settlement price the SBS Entity received from the clearing agency. As adopted, for cleared security-based swaps, Rule 15Fh-3(c)(1) requires an SBS Entity upon the request of the counterparty to provide to the counterparty the daily mark that the SBS Entity receives from the appropriate clearing agency.

In response to comments, the Commission is clarifying that to fulfill its obligation to provide the daily mark upon request, the SBS Entity may agree with the clearing agency, a clearing member or another agent, for such clearing agency, clearing member

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374 See IDC, supra note 5.

375 Id.

376 Id.

377 SIFMA (August 2015), supra note 5.

or other agent to provide the daily mark directly to the counterparty.[378] The SBS Entity, however, would retain the regulatory responsibility to provide the daily mark upon request. We understand that current market practice is for a clearing agency to provide access to end-of-day settlement prices to the counterparty. We believe that this flexibility is appropriate, as we believe errors in transmission are less likely to occur if the counterparty receives the information directly from the appropriate clearing agency, which is the source of the daily mark for cleared security-based swaps. In addition, these changes will align our rule more closely with the comparable CFTC rule, which allows for the counterparty to receive the daily mark for a cleared swap from access to the derivatives clearing organization or futures commodities merchant or from the Swap Entity, which should result in efficiencies for SBS Entities that have already established infrastructure to comply with the CFTC rule.[379] We note that an SBS Entity's obligation to provide the daily mark, if requested by the counterparty, exists for the life of the security-based swap between the SBS Entity and the counterparty. Depending on the form of clearing that is used to clear the security-based swap, the security-based swap between the SBS Entity and the counterparty may be terminated upon clearing by the clearing agency.[380]

Rule 15Fh-3(c)(1), as adopted, also requires that the SBS Entity provide the daily mark (as opposed to the end-of-day settlement price) upon request to the counterparty to

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378 See SIFMA (August 2015), supra note 5.

379 See 17 CFR 23.431(d); and CFTC Adopting Release, supra note 21.

380 If, for example, the security-based swap between the SBS Entity and counterparty is terminated upon novation by the clearing agency, the SBS Entity would no longer have any obligation to provide a daily mark to the original counterparty because a security-based swap no longer exists between them.

allow clearing agencies the flexibility to provide a different calculation of the mark in the future. As noted above, we understand that current market practice is for the clearing agency to provide an end-of-day settlement price as its mark. In addition, this change will conform our rule more closely to the parallel CFTC rule described above.

Uncleared Security-Based Swaps

The Commission is adopting Rule 15Fh-3(c)(2) as proposed. The Commission agrees with commenters[381] that the daily mark for uncleared security-based swaps will provide helpful transparency to counterparties during the lifecycle of a security-based swap by providing 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.[382] We continue to believe that even if the mark is calculated based on internal models or such indices, its provision by the SBS Entity will further the goal of providing helpful transparency into the SBS Entity's pricing and valuation of the security-based swap by providing a helpful reference point that the SBS Entity's counterparty can take into account when evaluating the pricing and valuation of the SBS. Thus, we disagree with the commenter[383] who believes that providing the daily mark will not enhance transparency.

As noted in the Proposing Release, 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

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381 See Barnard, supra note 5; Levin, supra note 5; IDC, supra note 5; SIFMA (August 2015), supra note 5.

382 See Proposing Release, 76 FR at 42410, supra note 3.

383 See AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5.

necessarily the sole determinant of how such margin is computed. Differences between the daily mark and computations for variation margin may result from adjustments for position size, position direction, credit reserve, hedging, funding, liquidity, counterparty credit quality, portfolio concentration, bid-ask spreads, or other costs. Moreover, we understand that the actual computations may be highly negotiated between the parties. Therefore, we decline to implement the commenter's suggestion that the basis for margining uncleared security-based swaps would satisfy the daily mark disclosure obligations.

For uncleared security-based swaps, Rule 15Fh-3(c)(2) as adopted defines the daily mark as 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 otherwise agree in writing to a different time.[384] The Commission continues to believe that, absent specific agreement by the parties otherwise, the rule will result in a daily mark that reflects daily changes in valuation and 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.[385]

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[384] As noted in the Proposing Release, 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. See Proposing Release, 76 FR at 42411 n.103, supra note 3.

[385] See Proposing Release, 76 FR at 42411, supra note 3.

As noted in the Proposing Release, 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 Rule 15Fh-3(c)(2).[386] 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. In this regard, the rule as adopted requires that the SBS Entity 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. One commenter suggested that the disclosures should include how the daily mark is calculated, including whether the daily mark is calculated based on inputs related to actual trade activity or using mathematical models, quotes and prices of other comparable securities, and whether those inputs came from third-party valuation service providers.[387] We believe that the requirement in the rule to disclose data sources, methodologies and assumptions encompasses this commenter's suggestion. On the other hand, another commenter has expressed concern that disclosure of data sources, methodology and assumptions would require the SBS Entity to disclose confidential, proprietary information about its

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386 See Proposing Release, 76 FR at 42411, supra note 3. See also Improving Counterparty Risk Management Practices, Counterparty Risk Management Policy Group (June 1999) at 7 (for use of the term "mid-market value"). For a discussion of mid-market value and costs, see also ISDA Research Notes, The Value of a New Swap, Issue 3 (2010), available at http://www.isda.org/researchnotes/pdf/NewSwapRN.pdf.

387 See IDC, supra note 5.

models.[388] We believe achieving the benefits underlying the statutory daily mark requirement require that each counterparty knows the data sources, methodology and assumptions used to calculate the mark. This information is critical for a counterparty to properly understand how the daily mark was calculated. The Commission believes that such disclosures will provide the counterparty useful context with which it can assess the quality of the mark received.[389] The Commission further agrees with the commenter that these disclosures would promote objectivity and transparency.[390] This commenter also suggested that this description of data sources, methodologies and assumptions should be required to constitute a complete and independently verifiable methodology for valuing each security.[391] To satisfy the duty to disclose the data sources, methodology and assumptions used to prepare the daily mark, SBS Entities may choose to provide to counterparties methodologies and assumptions sufficient to independently validate the output from a model generating the daily mark. The Commission does not foresee that these disclosures would require SBS Entities to disclose confidential, proprietary

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388 See SIFMA (August 2015), supra note 5.

389 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). The Commission understands that industry practice is often to include similar disclosures for margin calls in swap documentation, such as a credit support annex. See Proposing Release, 76 FR at 42411 n.109, supra note 3.

390 See Barnard, supra note 5.

391 See Barnard, supra note 5.

information about any model it may use to prepare the daily mark.[392] With these disclosures, counterparties should not be misled or unduly rely on the daily mark provided by the SBS Entities. Therefore, the Commission's final rule requires disclosure of the data sources, methodology and assumptions underlying the daily mark for uncleared security-based swaps.

A commenter suggested that the daily mark disclosures would assist in resolving valuation disputes during the term of the security-based swap.[393] Another commenter suggested requiring SBS Entities and their counterparties to have a clearly defined process for resolving any potential valuation disputes about daily marks for both cleared and uncleared security-based swaps.[394] The Commission notes that many market participants separately negotiate a dispute resolution mechanism for disagreements regarding valuations or include standardized language regarding dispute resolution in their agreements. At this time, the Commission declines to require parties to have a process for resolving valuation disputes and leaves the parties the flexibility to include such dispute resolution mechanisms in their negotiations if desired.

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392 We also note that methodologies and assumptions with respect to various models are disclosed in the context of financial statement reporting in footnotes to publicly available financial statements and Management's Discussion and Analysis in periodic reports under the Exchange Act without disclosing confidential proprietary information about models. See FASB Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures; 17 CFR 229.303; and 17 CFR 229.305.

393 See Barnard, supra note 5.

394 See IDC, supra note 5.

Two commenters suggested that Major SBS Participants should not be required to provide the daily mark for uncleared security-based swaps.[395] We believe that the benefits of Rule 15Fh-3(c), as discussed above, would inure equally to counterparties that transact with SBS Dealers as well as those that transact with Major SBS Participants. As we have noted above, even with the use of proprietary models to calculate the daily mark, we do not believe that the level of detail required to be disclosed would require an SBS Entity to disclose confidential proprietary information, whether the SBS Entity is an SBS Dealer or a Major SBS Participant. The commenter that expressed concerns regarding the reliability of the daily mark illustrates the necessity of the disclosure of the data sources, methodologies and assumptions underlying the calculation. Counterparties may evaluate the calculation and reliability of the daily mark calculation and determine for themselves whether or not to rely on the calculation. Furthermore, we do not find the arms-length nature of relationships with counterparties to be a persuasive argument to eliminate the daily mark requirement. To the extent that Major SBS Participants may be better informed about the valuations of security-based swaps due to significant information asymmetries in a market for opaque and complex products, disclosures may

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395 See MFA, supra note 5 (suggesting that Major SBS Participants will have to use proprietary models, which will force the Major SBS Participants to reveal proprietary information about their trading book positions and that such calculations would be sufficient to calculate a fund's total asset value but should not be relied upon by other market participants) and BlackRock, supra note 5 (arguing that the security-based swaps are arms-length transactions so the Major SBS Participant should not be required to develop systems to deliver the daily mark information, particularly since most transactions will be with an SBS Dealer). As an alternative to eliminating the daily mark requirement for Major SBS Participants, these commenters suggest that sophisticated counterparties should be permitted to opt out of receiving the daily mark. See discussion above regarding the Commission's reasons for not permitting counterparties to opt out of receiving the daily mark disclosure.

help inform counterparties concerning the valuations and material risks and characteristics of security-based swaps in the sometimes rapidly changing market environment.[396] The commenter also states that the vast majority of transactions by a Major SBS Participant would be with an SBS Dealer, in which circumstance, the disclosure is not required. As a result, we are not adopting the commenters' suggestions to exclude Major SBS Participants from the requirement of providing the daily mark disclosure at this time.

The Commission has considered the rationale raised by commenters and decided not to allow counterparties, even "sophisticated counterparties," to opt-out of the protections afforded by the daily mark disclosures. It is our understanding that counterparties have a range of sophistication and some are unlikely to have their own modeling capabilities or access to relevant data to calculate a daily mark themselves. We think it is appropriate to apply the rule so that counterparties receive the benefits of the daily mark and related disclosures, and do not think it appropriate to permit parties to "opt out" of the benefits of those provisions.

A commenter suggested modifying the rule text for uncleared security-based swaps to require that the SBS Entity disclose additional information concerning the daily mark to ensure a fair and balanced communication, including, as appropriate, that: (A) 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; (B) 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 (C) the daily mark may not necessarily

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[396] See Section II.C., supra.

be the value of the security-based swap that is marked on the books of the SBS Entity.[397] While the Commission declines to modify the rule text in this way, it does note that Rule 15Fh-3(g) as adopted requires an SBS Entity to communicate with its counterparty in a fair and balanced manner.[398] As a result, an SBS Entity may generally wish to consider disclosing this information.

Against this background, the Commission is not prescribing the means by which an SBS Entity determines the daily mark for an uncleared security-based swap. Commenters have made various suggestions as to additional requirements as to the inputs used for the daily mark calculation, such as requiring independent third-party quotes or limiting the context in which an SBS Entity can use its own bid and offer prices or requiring the daily mark to be an actionable quote.[399] At this time, the Commission declines to adopt these additional requirements. We believe that the rule as adopted will provide appropriate flexibility for SBS Entities to determine how to calculate the daily mark while providing disclosure of sufficient information – data sources, methodologies and assumptions, which are designed to allow the counterparty to assess the quality of the marks it receives from the SBS Entity. One of these commenters also suggested that using its own bid and offer prices for the calculation of the daily mark may present a conflict of interest for the SBS Entity.[400] If the SBS Entity is presented with a conflict of interest, we believe that the SBS Entity likely would disclose the conflict to the

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397 See SIFMA (August 2015), supra note 5 (requesting that the Commission insert additional required disclosures into Rule 15h-3(c) to ensure a fair and balanced communication).

398 See Section II.G.5, infra.

399 See Levin, supra note 5; and IDC, supra note 5.

400 Id.

counterparty pursuant to Rule 15Fh-3(b)(2) if the conflict is material. After receiving such disclosures, the counterparty will be able to factor that information into its assessment of the quality of the marks it receives. Consistent with the considerations outlined above, an SBS Entity may choose to do these calculations in-house or to use independent third-party valuation services, as suggested by a commenter.[401]

As noted above, Rule 15Fh-3(c)(2) requires an SBS Entity to disclose to the counterparty its data sources and a description of the methodology and assumptions used to prepare the daily mark for an uncleared security-based swap. Additionally, Rule 15Fh-3(c)(2) requires an SBS Entity to promptly disclose any material changes to the data sources, methodology, or assumptions during the term of the security-based swap. As noted in the Proposing Release, an SBS Entity is not 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.[402] For the purposes of this rule, a material change would generally include any change that has a material impact on the daily mark provided, such as if the data sources become unreliable or unavailable, as requested by one commenter.[403]

A commenter has requested that we eliminate the requirement to disclose data sources to harmonize more closely with the CFTC.[404] We believe that the requirement to disclose data sources is important for the counterparty to understand and assess the mark being provided. Therefore, we decline to eliminate this requirement.

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401 See IDC, supra note 5.

402 See Proposing Release, 76 FR at 42412, supra note 3.

403 See Levin, supra note 5.

404 See SIFMA (August 2015), supra note 5.

Applicable to Both Cleared and Uncleared Security-Based Swaps

Rule 15Fh-3(c) as adopted, does not mandate the means by which an SBS Entity must make the required disclosures and the Commission declines to mandate any particular means at this time. The Commission believes that SBS Entities are best positioned to determine the most appropriate means of communication of the disclosures. Commenters have made several specific suggestions for additional requirements regarding the means of communication of the daily mark.[405] One commenter suggested that we require the use of a secure website or electronic platform.[406] Another commenter requested web-based systems to be the preferred method of communication, but noted that since some market participants prefer more traditional methods of communication, web-based systems should not be required.[407] The commenter recommended requiring SBS Entities to have policies and procedures in place that reasonably ensure that any non-electronic means of communication is safe and secure and is otherwise comparable to web-based systems.[408] Additionally, the commenter generally requested that the Commission provide greater clarity on permissible methods for delivering daily mark disclosures, establish minimum requirements for the communication of daily marks (for instance, that the interfaces used provide counterparties with appropriate tools to initiate,

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405 Suggestions include: requiring interfaces that allow the counterparty to initiate, track and close valuation disputes; a method of communication designed to protect the confidentiality of the data and prevent any unintentional or fraudulent addition, modification or deletion of a valuation record; or require the use of a secure website or electronic platform. See Markit, supra note 5; IDC, supra note 5.

406 See IDC, supra note 5.

407 See Markit, supra note 5.

408 Id.

track and close valuation disputes), and require SBS Entities to ensure that the method of communication is designed to protect the confidentiality of the data and prevent any unintentional or fraudulent addition, modification or deletion of a valuation record.[409] The Commission continues to believe that such a method of communication would be an appropriate way for SBS Entities to discharge their obligations with respect to daily marks.[410]

One commenter suggested that we require an SBS Entity to have policies and procedures to reasonably ensure the safety and security of non-electronic means of communication.[411] To provide SBS Entities with flexibility in the manner of disclosure, we have not specified requirements with respect to the safety and security of either electronic or non-electronic communication of the daily mark. [412]

In the Proposing Release, the Commission stated 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 counterparty, although restrictions on dissemination to third parties are permissible.[413] One commenter supported the requirement that the

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409 Id.

410 See Proposing Release, 76 FR at 42412, supra note 3.

411 See Markit, supra note 5.

412 See the discussion of Timing and Manner of Certain Disclosures above in Section II.G.2.b. SBS Entities have to comply with their obligations under Section 15F(j) and Rule 15Fh-3(h). In addition, as a practical matter, we believe SBS Entities are likely to have such policies and procedures with respect to both electronic and non-electronic means of communication in the course of prudent business practices.

413 See Proposing Release, 76 FR at 42412, supra note 3.

daily mark disclosure be provided free of charge.[414] The daily mark disclosures are relevant to a counterparty's ongoing understanding and management of its security-based swap positions. We believe that counterparties to whom the SBS Entity provides the daily mark should have the opportunity to effectively use, retain, and analyze the information with respect to such management. Therefore, the Commission continues to believe that effective access to the daily mark information is necessary to ensure a counterparty's ability to manage its security-based swap positions over the life of the security-based swaps. Charging for provision of the daily mark, or allowing restrictions on the internal use of the daily mark by the counterparty with respect to managing their security-based swap positions, could undermine this objective. Thus, the Commission continues to believe 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 counterparty, although restrictions on dissemination to third parties are permissible.[415] Accordingly, the Commission has included these requirements in a new paragraph (3) to Rule 15Fh-3(c), as adopted.

f. Clearing Rights

Section 15F(h)(1)(D) of the Exchange Act authorizes the Commission to prescribe business conduct standards that relate to "such other matters as the Commission determines to be appropriate."[416] When an SBS Entity enters into a security-based swap

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414 See IDC, supra note 5.

415 For these purposes, providing the daily mark to a third party that is the agent of the counterparty, such as the independent representative of a special entity, for use consistent with its duties to the client, generally should be considered internal use.

416 15 U.S.C. 78o-10(h)(1)(D).

with a counterparty that is not an SBS Entity or a Swap Entity, Section 3C(g) of the Exchange Act establishes a right for the counterparty: (i) to select the clearing agency at which the security-based swap will be cleared, if the security-based swap is subject to the mandatory clearing requirement under Section 3C(a);[417] and (ii) to elect to require the clearing of the security-based swap, and to select the clearing agency at which the security-based swap will be cleared, if the security-based swap is not subject to the mandatory clearing requirement.[418]

i. Proposed Rule

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 or Swap Entity, 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. 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

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417 See Exchange Act 3C(g)(5)(A), 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.

418 See Exchange Act Section 3C(g)(5)(B), 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.

transaction.[419]

When the clearing requirements of Section 3C(a) 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. Under proposed Rule 15Fh-3(d)(1)(ii), 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.

For security-based swaps that are not subject to the clearing requirement under Exchange Act Section 3C(a), 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. Proposed Rule 15Fh-3(d)(2)(ii) would require the SBS Entity to disclose to the counterparty the clearing agencies that accept the security-based swap for clearing 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

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419 Section 3C(a)(1) of the Exchange Act provides that: "[i]t 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." 15 U.S.C. 78c-3(a)(1).

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.

ii. Comments on Proposed Rule

Four commenters addressed the required disclosure regarding clearing rights.[420] One commenter requested confirmation that a counterparty's clearing elections could affect the price of the security-based swap so long as this is disclosed to the counterparty at the time of the other disclosures regarding clearing.[421] Additionally, the commenter asked for clarification that standardized disclosure could be used to satisfy this requirement.[422] Another commenter recommended that the Commission not impose the clearing rights disclosure requirement on Major SBS Participants transacting with counterparties at arm's length, or alternatively, that the Commission allow ECP counterparties to opt out of receiving such disclosures.[423]

An additional commenter advocated for harmonizing the clearing rights disclosure requirement with the CFTC's parallel requirement.[424] Specifically, the commenter recommended eliminating the proposed requirements to disclose the names of the clearing agencies that accept the security-based swap for clearing, and through which

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420 See CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; MFA, supra note 5; SIFMA (August 2015), supra note 5.

421 See FIA/ISDA/SIFMA, supra note 5.

422 Id.

423 See MFA, supra note 5.

424 See SIFMA (August 2015), supra note 5.

the SBS Entity is authorized to clear the security-based swap.[425] The commenter argued that given the limited number of security-based swap clearing agencies, such additional disclosure is unlikely to be necessary, and that the Commission could always require it at a future date if the number increases.[426] Additionally, as discussed in Section II.B, the commenter advocated for adding an exception to the requirements regarding the disclosure of clearing rights to include security-based swaps that are intended to be cleared and that are either (1) executed on a registered national securities exchange or registered or exempt SEF and required to be cleared pursuant to Section 3C of the Exchange Act, or (2) anonymous.[427]

iii. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-3(d) largely as proposed, but with modifications. First, as discussed above in Section II.B, we are limiting an SBS Entity's disclosure obligations regarding clearing rights pursuant to Rule 15Fh-3(d) to counterparties whose identity is known to the SBS Entity at a reasonably sufficient time prior to the execution of the transaction.

The Commission is also making a second modification to the proposed rule. We also added the phrase "subject to Section 3C(g)(5) of the Act," to Rule 15Fh-3(d)(1)(ii) to clarify the source of the counterparty's right to select which of the clearing agencies described in paragraph (d)(1)(i) shall be used to clear the security-based swap.

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425 Id.

426 Id.

427 Id.

A commenter suggested that, due to the limited number of security-based swap clearing agencies, disclosure of clearing agencies by name was unnecessary.[428] Regardless of the current limited number of clearing agencies for security-based swaps, not every security-based swap will be accepted for clearing at every clearing agency, so the Commission believes that it is still useful for the counterparty to know whether the particular security-based swap is able to be cleared at a particular clearing agency.

Rule 15Fh-3(d) requires that disclosure be made before a transaction occurs. As noted in the Proposing Release, 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 will be cleared on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions the counterparty may execute with the SBS Entity.[429] While Rule 15Fh-3(d) does 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.[430]

Consistent with the discussion regarding manner of disclosures above in Section II.G.2.b, the Commission agrees with the commenter that SBS Entities could use standardized disclosure to satisfy Rule 15Fh-3(d).

The Commission also recognizes that a counterparty's clearing elections could affect the price of the security-based swap and recognizes that counterparties may wish to

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428 See SIFMA (August 2015), supra note 5.

429 See Proposing Release, 76 FR at 42413, supra note 3.

430 See Section 3C(a)(1) of the Exchange Act, 15 U.S.C. 78c-3(a)(1).

receive disclosures about the effect of clearing on the price. Although the rule does not explicitly require that the SBS Entity provide specific disclosures regarding the effect of clearing on the price of the security-based swap, the SBS Entity may wish to consider whether their obligations under Rule 15Fh-3(b)(1) to disclose the material risks and characteristics of the particular security-based swap, as well as their obligation pursuant to Rule 15Fh-3(g) to communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith (including providing a sound basis for evaluating the facts with regard to any particular security-based swap or trading strategy involving a security-based swap) may require such disclosure given their particular facts and circumstances.

One commenter recommended that the Commission not impose the clearing rights disclosure requirement on Major SBS Participants transacting with counterparties at arm's length or as an alternative allow ECP counterparties to opt out of receiving the clearing rights disclosure.[431] As explained in the Proposing Release, the required disclosure is intended to promote that, wherever possible and appropriate, derivatives contracts formerly traded exclusively in the OTC market are cleared through a regulated clearing agency.[432] The Commission has considered the concerns raised by commenters and determined that it is appropriate to require Major SBS Participants to provide such disclosures, and to not to permit counterparties to opt out of the protections provided by the business conduct rules. We believe that the benefits of Rule 15Fh-3(d), as discussed above, would inure equally to counterparties that transact with SBS Dealers as well as

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431 See MFA, supra note 5.

432 See MFA, supra note 5; Proposing Release 76 FR at 42413, supra note 3.

those that transact with Major SBS Participants.[433] We further believe that allowing counterparties to effectively opt out of the rule would deprive them of the express protections that the rules were intended to provide. As a result, we are not adopting the commenters' suggestions to allow counterparties to opt out of the clearing rights disclosure requirement when transacting with a Major SBS Participant nor to exclude Major SBS Participants from the requirement of providing the clearing rights disclosure at this time.

3. Know Your Counterparty

Section 15F(h)(1)(D) of the Exchange Act authorizes the Commission to prescribe business conduct standards that relate to "such other matters as the Commission determines to be appropriate."[434]

a. Proposed Rule

Proposed Rule 15Fh-3(e) would establish a "know your counterparty" requirement under which an SBS Dealer would be required to establish, maintain and enforce 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. For purposes of the proposed rule, "essential facts" would be defined as: (i) facts required to comply with applicable laws, regulations and rules; (ii) facts required to implement 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

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433 See Section II.C above.

434 15 U.S.C. 78o-10(h)(1)(D).

the counterparty is a special entity, such background information regarding the independent representative as the SBS Dealer reasonably deems appropriate.[435]

b. Comments on the Proposed Rule

Four commenters addressed the proposed know your counterparty requirement.[436] Two commenters generally supported the proposed rule.[437] However, one requested clarification that since the requirement only applies to "known" counterparties, it would not apply to an SBS Dealer transacting on a SEF or other electronic execution platform where such SBS Dealer only learns the identity of the counterparty immediately before the execution and must execute the transaction within a limited time frame after learning the counterparty's identity.[438] The other commenter asserted that the requirement should apply to Major SBS Participants in addition to SBS Dealers.[439]

A third commenter expressed concern that the proposed rule would inappropriately empower SBS Dealers to adopt and enforce rules and to collect information about independent representatives.[440] The commenter asserted that the use of the word "enforce" in the proposed rule suggests that the rule would improperly empower SBS Dealers to adopt policies and procedures that have the force of law with respect to their counterparties.[441] Specifically, the commenter asserted that the proposed rule

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435 Proposed Rule 15Fh-3(e)(1)-(4).

436 See CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; ABC, supra note 5; SIFMA (August 2015), supra note 5.

437 See CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5.

438 See FIA/ISDA/SIFMA, supra note 5.

439 See CFA, supra note 5.

440 See ABC, supra note 5.

441 Id.

authorizes SBS Dealers to collect unlimited information about the representatives of special entities, as well as proprietary information, which would give dealers an unfair competitive advantage.[442] The commenter argued that SBS Dealers should be required to adopt policies that comply with the law, and that these policies should not be binding to the extent they require more than the law requires.[443]

A fourth commenter recommended eliminating the proposed requirement to collect background information regarding the independent representative of a special entity.[444] First, the commenter asserted that this change would harmonize the Commission's rule with the parallel CFTC requirement.[445] Second, the commenter stated that the proposed requirement would be duplicative of the requirements imposed on SBS Entities acting as counterparties to special entities pursuant to Rule 15Fh-5.[446] Additionally, as discussed in Section II.B, the commenter advocated for adding an exception to the know your counterparty requirement to cover security-based swaps that are intended to be cleared, executed on a registered national securities exchange or registered or exempt SEF, and of a type that is, as of the date of execution, required to be cleared pursuant to Section 3C of the Exchange Act.[447]

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442 Id.

443 Id.

444 See SIFMA (August 2015), supra note 5.

445 Id.

446 Id.

447 Id.

c. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-3(e) with two modifications. First, in response to a specific suggestion from a commenter,[448] the Commission is eliminating the proposed requirement that an SBS Dealer obtain background information regarding the independent representative of a special entity counterparty, as the SBS Dealer reasonably deems appropriate. The Commission agrees with the commenter that the proposed requirement would have been duplicative of the requirements imposed on SBS Entities acting as counterparties to special entities pursuant to Rule 15Fh-5 (discussed below in Section II.H).

Second, the Commission is adding the word "written" before policies and procedures in the rule text to clarify that the policies and procedures required by the rule must be written. The Commission believes that this change clarifies the proposal and reflects the requirement in Rule 15Fh-3(h), discussed in Section II.G.6 below, that an SBS Dealer establish, maintain and enforce written policies and procedures that are reasonably designed to prevent violations of the applicable federal securities laws and rules and regulations thereunder. Thus, as adopted, Rule 15Fh-3(e) requires SBS Dealers to "establish, maintain and enforce written policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each counterparty."

In response to concerns raised by a commenter,[449] the Commission is clarifying that the provision stating that an SBS Dealer shall "establish, maintain and enforce" policies and procedures does not vest such policies and procedures with force of law with

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448 See SIFMA (August 2015), supra note 5.

449 See ABC, supra note 5.

respect to their counterparties. An SBS Dealer would, however, have an obligation to enforce (i.e., follow) its internal policies and procedures.

We have determined, as proposed, not to apply the rule where an SBS Dealer does not know the identity of its counterparty. We are not adopting the suggestion of one commenter that we provide an additional exception to cover security-based swaps that are intended to be cleared, executed on a registered national securities exchange or registered or exempt SEF, and of a type that is, as of the date of execution, required to be cleared pursuant to Section 3C of the Exchange Act, even if not anonymous.[450] However, we note that Rule 15Fh-3(e) requires SBS Dealers to establish policies and procedures that are "reasonably designed to obtain and retain a record of the essential facts concerning each [known counterparty] that are necessary for conducting business with such counterparty." Reasonably designed policies and procedures established pursuant to Rule 15Fh-3(e) may address situations in which there are few, if any, essential facts that are necessary for conducting business with a counterparty. For example, if the only security-based swaps that an SBS Dealer enters into with a counterparty are intended to be cleared security-based swaps that are executed on a registered exchange or SEF and of a type that is, as of the date of execution, required to be cleared pursuant to Section 3C of the Exchange Act, then there may be few, if any, essential facts that the SBS Dealer needs to know about such counterparty in that circumstance.

In response to a commenter's request for clarification that since the requirement only applies to "known" counterparties, it would not apply to an SBS Dealer transacting on a SEF or other electronic execution platform where such SBS Dealer only learns the

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450 See SIFMA (August 2015), supra note 5.

identity of the counterparty immediately before the execution and must execute the transaction within a limited time frame after learning the counterparty's identity,[451] the Commission notes that Rule 15Fh-3(e) does not contain a specific timing requirement. Rule 15Fh-3(e) requires SBS Dealers to establish policies and procedures that are "reasonably designed to obtain and retain a record of the essential facts concerning each [known counterparty] that are necessary for conducting business with such counterparty." To be "reasonably designed" such policies and procedures generally should provide for the collection of counterparty information prior to execution of a transaction with that counterparty. However, if the SBS Dealer does not learn a counterparty's identity until immediately prior to or subsequent to execution, then it would be reasonable for collection to occur within a reasonable time after the SBS Dealer learns the identity of the counterparty.[452]

As noted in the Proposing Release, the "know your counterparty" obligations under Rule 15Fh-3(e) are a modified version of the "know your customer" obligations imposed on other market professionals, such as broker-dealers, when dealing with customers.[453] Although the statute does not require the Commission to adopt a "know

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451 See FIA/ISDA/SIFMA, supra note 5.

452 The application of the know your counterparty requirement in these circumstances does not affect the application of the other business conduct obligations in Rules 15Fh-3(b) and (d), 15Fh-4(b), 15Fh-5, and 15Fh-6, including the exceptions to the application of those rules where the identity of the counterparty is not known to the SBS Entity at a reasonably sufficient time prior to execution of the transaction, and, in the case of Rules 15Fh-4(b), 15Fh-5 and 15Fh-6, executed on a registered national securities exchange or registered or exempt SEF.

453 See Proposing Release, 76 FR at 42414, supra note 3. Cf. FINRA Rule 2090 ("[e]very 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

your counterparty" standard, the Commission continues to believe that such a standard is consistent with basic principles of legal and regulatory compliance, and operational and credit risk management.[454] Further, the Commission continues to believe that entities that currently operate as SBS Dealers typically would already have in place, as a matter of their normal business practices, policies and procedures that could potentially satisfy the requirements of the rule.[455]

The Commission is applying the requirements in Rule 15Fh-3(e) to SBS Dealers but declines to apply them to Major SBS Participants, as suggested by a commenter.[456] As discussed above in Section II.C, the Commission has determined that where a business conduct requirement is not expressly addressed by the Dodd-Frank Act, the rules generally will not apply to Major SBS Participants.

4. Recommendations by SBS Dealers

Section 15F(h)(1)(D) of the Exchange Act authorizes the Commission to prescribe business conduct standards that relate to "such other matters as the Commission determines to be appropriate."[457] Additionally, Section 15F(h)(3)(D) of the Exchange authorizes the Commission to establish "such other standards and requirements as the

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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 Rule 15Fh-3(e). 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.

454 See Proposing Release, 76 FR at 42414, supra note 3.

455 Id.

456 See CFA, supra note 5.

457 15 U.S.C. 78o-10(h)(1)(D).

Commission may determine are appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this Act."[458]

a. Proposed Rule

i. General

Proposed Rule 15Fh-3(f) generally would require an SBS Dealer that recommends a security-based swap or trading strategy involving a security-based swap to a counterparty, other than an SBS Entity or Swap Entity, to have a reasonable basis for believing that the recommended security-based swap or trading strategy is suitable. Specifically, 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 recommended security-based swap or trading strategy is suitable for at least some counterparties. Additionally, proposed Rule 15Fh-3(f)(1)(ii) would require an SBS Dealer to have a reasonable basis to believe that the recommended security-based swap or trading strategy is suitable for the particular counterparty that is the recipient of the SBS Dealer's recommendation ("customer-specific suitability"). Under proposed Rule 15Fh-3(f)(1)(ii), to establish a reasonable basis to believe that a recommendation is suitable for a particular counterparty, 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.

ii. Institutional Suitability Alternative

Proposed Rule 15Fh-3(f)(2) would provide an alternative to the general suitability

[458] 15 U.S.C. 78o-10(h)(3)(D).

requirements, under which an SBS Dealer could fulfill its suitability 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 for the counterparty.

The Commission sought comment on whether different categories of ECPs should be treated differently for purposes of suitability determinations.[459] The Proposing Release noted that, under our proposed rules, an SBS Dealer could rely on the institutional suitability alternative 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."[460] In contrast, under FINRA rules, in order to apply an analogous institutional suitability alternative, a broker-dealer must be dealing with a person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.[461] The Proposing Release asked whether the Commission should apply a different standard of suitability depending on whether the counterparty would be

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459 See Proposing Release, 76 FR at 42417, supra note 3.

460 See Section 1a(18)(A)(xi) of the Commodity Exchange Act, 7 U.S.C. 1a(18)(A)(xi).

461 See FINRA Rule 2111(b) (referring to FINRA Rule 4512(c)).

protected as a retail investor under FINRA rules when the SBS Dealer is also a registered broker-dealer.[462] More generally, the Commission sought comment on whether the institutional suitability alternative available under proposed Rule 15Fh-3(f)(2) should be limited to counterparties that would not be protected as retail investors under FINRA rules or another category of counterparties.

iii. Special Entity Suitability Alternative

Proposed Rule 15Fh-3(f)(3) would provide another alternative to the general suitability requirements for SBS Dealers transacting with special entity counterparties. Under proposed Rule 15Fh-3(f)(3), an SBS Dealer would be deemed to satisfy its suitability obligations with respect to a special entity counterparty if the SBS Dealer either is acting as an advisor to the special entity and complies with proposed Rule 15Fh-4(b),[463] or is deemed not to be acting as an advisor to the special entity pursuant to proposed Rule 15Fh-2(a).

b. Comments on the Proposed Rule

i. General

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462 Under FINRA rules, institutional suitability is limited to transactions with so-called "institutional" investors:

(1) a bank, savings and loan association, insurance company or registered investment company;

(2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act or with a state securities commission (or any agency or office performing like functions); or

(3) any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.

See FINRA Rule 4512(c) (regarding definition of "institutional account").

463 As discussed below in Section II.H.2, proposed Rule 15Fh-4(b) would impose certain requirements on SBS Dealers acting as advisors to special entities.

Six commenters addressed the suitability requirements.[464] Three commenters recommended expanding the suitability requirements.[465] One commenter suggested two changes to the rule: (1) clarifying that SBS Dealers would be prohibited from recommending to investors financial products that the dealers believe will fail; and (2) requiring that an SBS Dealer making recommendations regarding a certain product or type of product have the background necessary to understand the product.[466] Another commenter urged the Commission to consider developing suitability standards for the types of financial products that can be sold to state and local governments, including those products in the swaps arena.[467] A third commenter suggested that the Commission conform its requirements to the CFTC's proposal, noting that the CFTC proposal would have required the dealer to obtain information through reasonable due diligence concerning the counterparty's financial situation and needs, objectives, tax status, ability to evaluate the recommendation, liquidity needs, risk tolerance or other relevant information.[468] The commenter also recommended explicitly requiring SBS Dealers to: (1) gather information sufficient to make the suitability assessment; and (2) maintain sufficient documents to allow the Commission to effectively enforce compliance.[469] Additionally, the commenter asserted that the suitability requirement should apply to all

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464 See Levin, supra note 5; GFOA, supra note 5; CFA, supra note 5; Barnard, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

465 See Levin, supra note 5; GFOA, supra note 5; CFA, supra note 5.

466 See Levin, supra note 5.

467 See GFOA, supra note 5.

468 See CFA, supra note 5. The CFTC subsequently adopted a rule that is similar to proposed Rule 15Fh-3(f). See CFTC Adopting Release, 77 FR at 9771-9774, supra note 21.

469 See CFA, supra note 5.

SBS Entities, not just SBS Dealers, noting that the suitability obligation would only be imposed on a Major SBS Participant if the Major SBS Participant makes a recommendation to a non-SBS Entity.[470] While the commenter supported the exclusion from the suitability requirement for recommendations to other SBS Entities, it strongly opposed any additional exclusions (e.g., for recommendations to broker-dealers or other market intermediaries who are not SBS Entities). Finally, the commenter also strongly opposed limiting the requirement to recommendations to retail investors.[471]

Two other commenters recommended narrowing the suitability requirements.[472] One commenter suggested that any suitability standard for SBS Dealers be applied at the least granular level (e.g., on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions between the parties, as appropriate).[473] The second commenter opposed the suitability requirement more broadly, stating that Congress did not impose such a requirement.[474] The commenter suggested, as an alternative to the proposed rule, that any suitability requirement for recommendations to

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470 Id.

471 Id. The commenter explained that, under the institutional suitability alternative, "the SBS Dealer wouldn't even have to have a reasonable basis to believe that the swap was suitable . . . for the particular counterparty to the transaction." The commenter expressed its concern that:

> Given the profits at stake, SBS Dealer will have strong incentives to conclude that the counterparty is capable of evaluating the transaction. Counterparties who turn to the derivatives markets out of questionable motives will have equally strong incentives to assert their capacity to independently evaluate investment risk. And even those with purer motives may be reluctant to confess to a lack of expertise.

472 See Barnard, supra note 5; FIA/ISDA/SIFMA, supra note 5.

473 See Barnard, supra note 5.

474 See FIA/ISDA/SIFMA, supra note 5.

counterparties other than special entities be imposed through a requirement to adopt and enforce policies and procedures reasonably designed to assess the suitability of recommendations, and that the proposed rule be incorporated as guidance establishing a safe harbor for whether an SBS Dealer's policies are reasonable.[475] The commenter also asserted that the proposed rule could conflict with the specific suitability rules of other (unidentified) regulators, and accordingly, urged the Commission to clarify that an SBS Dealer that complies with suitability requirements of another qualifying regulator will also be deemed to have adopted and enforced reasonable suitability policies under the Commission's rule.[476] Finally, the commenter recommended allowing sophisticated counterparties to opt out of suitability protection, noting that some counterparties will find the suitability analysis burdensome and intrusive, and that the costs of the proposed suitability rule for those counterparties will likely outweigh any benefits.[477]

Finally, a sixth commenter advocated for harmonizing the suitability requirement in proposed Rule 15Fh-3(f)(1)(i) with the CFTC's parallel requirement.[478] Specifically, the commenter recommended changing the wording of the suitability requirement in proposed Rule 15Fh-3(f)(1)(i) to "undertake reasonable diligence to understand the potential risks and rewards associated with the recommended security-based swap or trading strategy involving a security-based swap."[479]

ii. Institutional Suitability Alternative

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475 Id.

476 Id.

477 Id.

478 See SIFMA (August 2015), supra note 5.

479 Id.

Three commenters submitted comments regarding the institutional suitability alternative in proposed Rule 15Fh-3(f)(2).[480] Two commenters expressed concerns regarding the proposed alternative.[481] One commenter expressed concern that the counterparty representations upon which the SBS Dealer would rely may become outdated or boilerplate language that is inappropriate for the counterparty to which it is directed.[482] Accordingly, the commenter suggested requiring SBS Dealers to conduct routine audits to ensure that these institutional level suitability determinations are not over-utilized, that they are appropriate for the particular counterparties involved, and that the appropriate written documentation was provided and signed in applicable transactions.[483] Additionally, the commenter recommended that as part of that audit process, and to prevent inaccurate determinations, SBS Dealers should be required to test, perhaps on an annual basis, whether counterparties continue to have the personnel and expertise needed to conduct independent evaluations of the security-based swap products being marketed.[484]

The second commenter strongly opposed the institutional suitability alternative, asserting that the complexity and opacity of structured finance products has made them impenetrable to all but the most sophisticated industry experts.[485] At a minimum, the commenter recommended that if the Commission adopts the institutional suitability

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480 See Levin, supra note 5; CFA, supra note 5; SIFMA (August 2015), supra note 5.

481 See Levin, supra note 5; CFA, supra note 5.

482 See Levin, supra note 5.

483 Id.

484 Id.

485 See CFA, supra note 5.

alternative, it should require an SBS Dealer to have a reasonable basis to believe its counterparty has the capacity to absorb potential losses related to the security-based swap or trading strategy being recommended.[486]

A third commenter advocated for harmonizing the institutional suitability alternative with the CFTC's parallel provision, citing potential counterparty confusion.[487] Specifically, the commenter recommended that the Commission: (1) clarify that the institutional suitability alternative only satisfies an SBS Dealer's customer-specific suitability obligation in proposed Rule 15Fh-3(f)(1)(ii), not its suitability obligation in proposed Rule 15Fh-3(f)(1)(i); and (2) add a safe harbor providing that an SBS Dealer can satisfy its requirement to make a reasonable determination that the counterparty is capable of independently evaluating investment risks with regard to the security-based swap if the SBS Dealer receives written representations from the counterparty regarding the counterparty's compliance with appropriate policies and procedures.[488]

iii. Special Entity Suitability Alternative

Four commenters submitted comments regarding the suitability alternative for special entity counterparties in proposed Rule 15Fh-3(f)(3).[489] Three commenters supported the proposed rule.[490] Another commenter recommended adding a requirement to the institutional suitability alternative, in lieu of the special entity suitability

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486 Id.

487 See SIFMA (August 2015), supra note 5.

488 Id.

489 See BlackRock, supra note 5; GFOA, supra note 5; ABC, supra note 5; SIFMA (August 2015), supra note 5.

490 See BlackRock, supra note 5; GFOA, supra note 5; ABC, supra note 5.

alternative, that the SBS Dealer comply with the requirements of Rule 15Fh-4(b) (regarding acting as an advisor to a special entity) if the SBS Dealer's recommendation to a special entity would cause it to be acting as an advisor to the special entity.[491]

c. Response to Comments and Final Rule

i. General

After considering the comments, the Commission is adopting Rule 15Fh-3(f)(1) with two modifications. The first modification is to rephrase the suitability obligation in proposed Rule 15Fh-3(f)(1)(i), in response to a specific suggestion from a commenter,[492] to make it consistent with the CFTC's parallel suitability requirement in Commodity Exchange Act Rule 23.434(a)(1), which explicitly requires SBS Dealers to understand the risk-reward tradeoff of their recommendations. We believe that our proposed formulation and the CFTC's formulation would have achieved the same purpose. However, to alleviate concerns among commenters that compliance with the two rules would require anything different, we are harmonizing the wording of our rule with the CFTC's parallel suitability obligation.[493] As adopted, Rule 15Fh-3(f)(1)(i) requires an SBS Dealer that recommends a security-based swap or trading strategy involving a security-based swap to a counterparty, other than an SBS Entity or Swap Entity, to

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491 See SIFMA (August 2015), supra note 5.

492 See SIFMA (August 2015), supra note 5. The Commission believes this change also responds to another commenter's concern that the proposed rules could conflict with the CFTC's suitability rule. See FIA/ISDA/SIFMA, supra note 5.

493 See CFTC Adopting Release, 77 FR at 9771-9774, supra note 21. The new formulation is also consistent with FINRA's approach to this aspect of suitability. See Supplementary Material .05(a) to FINRA Rule 2111 (effective July 9, 2012)("[a] member's or associated person's reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy").

"undertake reasonable diligence to understand the potential risks and rewards associated with the recommended security-based swap or trading strategy involving a security-based swap." Consistency with the CFTC standard will result in efficiencies for entities that have already established infrastructure to comply with the CFTC standard. Consistent wording will also allow SBS Entities to more easily analyze compliance with the Commission's rule against their existing activities to comply with the CFTC's parallel suitability rule for Swap Entities.

The second modification the Commission is making is to add the phrase "involving a security-based swap" to the final line of the customer-specific suitability obligation in proposed Rule 15Fh-3(f)(1)(ii) to modify "trading strategy." Accordingly, Rule 15Fh-3(f)(1)(ii), as adopted, requires an SBS Dealer that recommends a security-based swap or trading strategy involving a security-based swap to a counterparty, other than an SBS Entity or Swap Entity, to have a reasonable basis to believe that a recommended security-based swap or trading strategy involving a security-based swap is suitable for the counterparty, and to establish a reasonable basis for a recommendation, 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 "involving a security-based swap." The Commission does not believe that this is a substantive change. It simply clarifies that the term trading strategy as used in the final line of the rule is the same as recommended trading strategy involving a security-based swap that is referenced earlier in the rule.

As noted in the Proposing Release, although suitability is not expressly addressed in Section 15F(h) of the Exchange Act, the obligation to make only suitable recommendations is a core business conduct requirement for broker-dealers and other financial intermediaries.[494] Municipal securities dealers also have a suitability obligation when recommending municipal securities transactions to a customer.[495] 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 Rule 15Fh-3(f). In particular, an SBS Dealer that also is a registered broker-dealer and a FINRA member, would be subject to FINRA's suitability requirements in connection with the recommendation of a security-based swap or trading strategy involving a security-based swap.[496] Rule 15Fh-3(f) is intended to

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494 See Proposing Release, 76 FR at 42415, supra note 3. See also, e.g., FINRA Rules 2090 and 2111 (effective Jul. 9, 2012); Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943) (enforcing suitability obligations under the antifraud provisions of the Exchange Act).

495 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.

496 See FINRA Rule 2111. Under FINRA rules, unless a customer is an "institutional account" that meets the requirements of the institutional account exemption, he or she would be entitled to the protections provided by retail suitability obligations in the broker-dealer context. An "institutional account" means the account of a bank, savings and loan association, insurance company, registered investment company, registered investment adviser or any other person (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million. See FINRA Rule 2111(b) (referring to FINRA Rule 4512(c)).

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.[497]

The Commission continues to believe that the determination of whether an SBS Dealer has made a recommendation that triggers suitability obligations 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.[498] This follows the FINRA approach to what constitutes a recommendation for purposes of FINRA's suitability rule.[499] In the context of the FINRA suitability rule, 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."[500] We note that this could include a call to action regarding buying, selling, materially amending or early termination of a security-based swap. The more individually tailored the

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497 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.

498 See Proposing Release, 76 FR at 42415, supra note 3.

499 See FINRA Regulatory Notice 12-25 (May 2012) Q.2 and Q.3 (regarding the scope of "recommendation").

500 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").

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 continues to believe that this approach to determining whether a recommendation has taken place should apply in the context of Rule 15Fh-3(f) as well.[501]

As noted in the Proposing Release, 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.[502] Again, this follows the FINRA approach to determining whether a recommendation has occurred.[503] Furthermore, compliance with the requirements of the other business conduct rules, in particular, Rules 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."[504]

We believe that the suitability obligation in Rule 15Fh-3(f)(1)(i) should address one commenter's concerns about the possibility that an SBS Dealer will recommend a

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501 See Proposing Release, 76 FR at 42415, supra note 3.

502 See Proposing Release, 76 FR at 42415, supra note 3.

503 See Supplementary Material .03 to FINRA Rule 2090.

504 Additionally, as discussed in Section I.E, supra, the duties imposed on an SBS Dealer under the business conduct rules are specific to this context, and are in addition to any duties that may be imposed under other applicable law. Thus, an SBS Dealer must separately determine whether it is subject to regulation as a broker-dealer, an investment adviser, a municipal advisor or other regulated entity.

financial product that it believes will fail or that it does not have the necessary background to understand.[505] When making recommendations, SBS Dealers are always required to meet their suitability obligation in Rule 15Fh-3(f)(1)(i), regardless of whether they avail themselves of the institutional suitability alternative to meet their customer-specific suitability obligations. In that respect, SBS Dealers will always be required to undertake reasonable diligence to understand the risks and rewards behind any recommended security-based swap.

With respect to another commenter's concerns about SBS Dealers' gathering sufficient information to make the customer-specific suitability assessment,[506] the Commission notes that Rule 15Fh-3(f)(1)(ii) requires an SBS Dealer to "have a reasonable basis to believe" that a recommended security-based swap or trading strategy is suitable for the counterparty. To establish that reasonable basis, the rule requires the SBS Dealer 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." The list of "relevant information" in the rule is exemplary, not exhaustive. Whether an SBS Dealer has a reasonable basis to believe that a recommended security-based swap or trading strategy is suitable for the counterparty is a determination that depends on the facts and circumstances of the particular situation.

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505 See Levin, supra note 5.

506 See CFA, supra note 5. In response to the commenter's other concern regarding the Commission requiring SBS Dealers to maintain sufficient documentation to effectively enforce compliance with the suitability rule, we note that the Commission has separately proposed recordkeeping requirements for SBS Dealers. See Recordkeeping Release, 79 FR at 25135, supra note 242.

The Commission declines to apply Rule 15Fh-3(f) to Major SBS Participants, as suggested by one commenter.[507] As discussed above in Section II.C, where a business conduct requirement is not expressly addressed by the Dodd-Frank Act, the Commission is generally not applying such a rule to Major SBS Participants. The Commission continues to believe that it is appropriate not to impose suitability obligations on Major SBS Participants, given that, by definition, Major SBS Participants are not engaged in security-based swap dealing activity at levels above the de minimis threshold.[508] However, if a Major SBS Participant is, in fact, recommending security-based swaps or trading strategies involving security-based swaps to a counterparty, this would indicate that the Major SBS Participant is actually engaged in security-based swap dealing activity.[509] If a Major SBS Participant engages in such activity above the de minimis threshold in Exchange Act Rule 3a71-2, it would need to register as an SBS Dealer and, as such, would need to comply with the suitability obligations imposed by Rule 15Fh-3(f).

Further, Rule 15Fh-3(f) will not impose suitability obligations on an SBS Dealer transacting with an SBS Entity or Swap Entity. The Commission continues to believe that these types of counterparties, which are professional intermediaries or major participants in the swaps or security-based swaps markets, would not need the protections

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507 See CFA, supra note 5.

508 See Exchange Act Rule 3a61-1(a)(1) (limiting the definition of "major security-based swap participant" to persons that are not security-based swap dealers).

509 See Proposing Release, 76 FR at 42416 n.140, supra note 3. See also Definitions Adopting Release, 77 FR at 30618, supra note 115 ("Advising a counterparty as to how to use security-based swaps to meet the counterparty's hedging goals, or structuring security-based swaps on behalf of a counterparty, also would indicate security-based swap dealing activity.").

that would be afforded by this rule. However, taking into account the concerns of one commenter,[510] the Commission is not adopting any additional exclusions to the rule at this time, nor is the Commission applying the suitability obligations at the least granular level (e.g., on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions between the parties), as suggested by another commenter.[511] The Commission is also not, as suggested by one commenter,[512] providing an opt out from the rule or a policies and procedures alternative. As discussed above in Sections II.A.3.d and II.E, the Commission believes that it is appropriate to apply the suitability rule so that counterparties receive the benefits of the protections provided by the rule; permitting parties to "opt out" of the benefits of the rule or providing a policies and procedures alternative would undermine its core purpose of protecting counterparties. However, while we are not adopting an opt out provision or a policies and procedures alternative, the Commission has determined to permit means of compliance with Rule 15Fh-3(f) that should promote efficiency and reduce costs (e.g., reliance on representations pursuant to Rule 15Fh-1(b)) and allowing SBS Dealers to take into account the sophistication of the counterparty by way of the institutional suitability alternative in Rule 15Fh-3(f)(2) (described below).

The Commission is not adopting one commenter's suggestion to impose additional standards for the types of financial products that can be sold to state and local

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510 See CFA, supra note 5.

511 See Barnard, supra note 5.

512 See FIA/ISDA/SIFMA, supra note 5.

governments, including security-based swaps.[513] We have determined that additional standards are not needed and that the rules we are adopting appropriately regulate the business conduct of the professional market intermediaries selling these products. We also note that the MSRB is developing a regulatory framework for municipal advisors, including detailed standards of conduct that municipal advisors owe to municipal entities.[514]

ii. Institutional Suitability Alternative and Special Entity Suitability Alternative

After considering the comments, the Commission is adopting Rules 15Fh-3(f)(2)-(4) with a number of modifications. First, in response to a specific suggestion from a commenter,[515] the Commission is correcting a typographical error in proposed Rule 15Fh-3(f)(2). The institutional suitability alternative in proposed Rule 15Fh-3(f)(2) was intended to provide SBS Dealers with an alternative method to fulfill their customer-

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513 See GFOA, supra note 5.

514 See, e.g., Order Granting Approval of a Proposed Rule Change, as Modified by Amendment No. 1 and Amendment No. 2, Consisting of Proposed New Rule G-42, on Duties of Non-Solicitor Municipal Advisors, and Proposed Amendments to Rule G-8, on Books and Records to be Made by Brokers, Dealers, Municipal Securities Dealers, and Municipal Advisors, Exchange Act Release No. 76753 (Dec. 23, 2015), 80 FR 81614 (Dec. 30, 2015); Order Granting Approval of a Proposed Rule Change Consisting of Proposed Amendments to Rule G-20, on Gifts, Gratuities and Non-Cash Compensation, and Rule G-8, on Books and Records to be Made by Brokers, Dealers, Municipal Securities Dealers, and Municipal Advisors, and the Deletion of Prior Interpretive Guidance, Exchange Act Release No. 76381 (Nov. 6, 2015), 80 FR 70271 (Nov. 13, 2015); see also Notice of Filing of a Proposed Rule Change Consisting of Proposed Amendments to Rule G-37, on Political Contributions and Prohibitions on Municipal Securities Business, Rule G-8, on Books and Records, Rule G-9, on Preservation of Records, and Forms G-37 and G-37x, Exchange Act Release No. 76763 (Dec. 23, 2015), 80 FR 81709 (Dec. 30, 2015).

515 See SIFMA (August 2015), supra note 5.

specific suitability obligations described in proposed Rule 15Fh-3(f)(1)(ii), not their suitability obligations described in proposed Rule 15Fh-3(f)(1)(i). Accordingly, the cross-reference in the proposed rule should have been to "paragraph (f)(1)(ii)," not to "paragraph (f)(1)." The Commission is correcting this cross-reference in the final rules.

Second, in response to concerns raised by a commenter,[516] the Commission is also limiting the availability of the institutional suitability alternative to recommendations made to "institutional counterparties." This is a change from the proposed rule under which the institutional suitability alternative would have been available with respect to recommendations made to any counterparty. Rule 15Fh-3(f)(4), as adopted, defines the term "institutional counterparty" for these purposes to mean a counterparty that is an eligible contract participant as defined in clauses (A)(i), (ii), (iii), (iv), (viii), (ix) or (x), or clause (B)(ii) (other than a person described in clause (A)(v)) of Section 1a(18) of the Commodity Exchange Act and the rules and regulations thereunder, or any person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. This more closely aligns the treatment of the persons who may most need the protections of the suitability requirements with their treatment under FINRA rules, which limit the application of FINRA's analogous institutional suitability alternative to recommendations to persons (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.[517] Rule 15Fh-3(f)(2), as adopted, generally provides that an SBS Dealer may rely on the institutional suitability alternative when making recommendations to institutional counterparties. For

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516 See CFA, supra note 5.

517 See FINRA Rule 2111(b) (referring to FINRA Rule 4512(c)).

a counterparty that is not an institutional counterparty, an SBS Dealer will need to have or obtain relevant information regarding the counterparty to establish a reasonable basis to believe that a recommended security-based swap or trading strategy involving a security-based swap is suitable for the counterparty.[518]

Third, in response to specific suggestions from a commenter, the Commission is making changes to harmonize the institutional and special entity suitability alternatives with the CFTC's parallel provisions.[519] Specifically, the Commission is eliminating the separate special entity suitability alternative. Accordingly, an SBS Dealer may satisfy its customer-specific suitability obligations in Rule 15Fh-3(f)(1)(ii) with respect to any institutional counterparty, including a special entity counterparty that meets the $50 million asset threshold described above, by complying with the requirements of the institutional suitability alternative in Rule 15Fh-3(f)(2). Having a single institutional suitability alternative will result in greater consistency with the CFTC's parallel rule, which will result in efficiencies for entities that have already established infrastructure to comply with the CFTC standard.[520] However, the Commission is not adopting the commenter's suggestion to add a new fourth prong to Rule 15Fh-3(f)(2) that requires an

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518 See Rule 15Fh-3(f)(1)(ii).

519 See SIFMA (August 2015), supra note 5. See also CFTC Adopting Release, 77 FR at 9771-9774, supra note 21.

520 See SIFMA (August 2015), supra note 5 (noting that "[a]lthough conforming to the [parallel CFTC suitability rule] would impose additional diligence and compliance requirements on the [SBS Dealer], these requirements would not result in material costs because [SBS Dealers] are already complying with the same requirements under the [parallel CFTC rule]"). However, we note that the CFTC does not limit the availability of its institutional suitability alternative to recommendations to "institutional counterparties." See Commodity Exchange Act Rule 23.434(b).

SBS Dealer to comply, in addition to the requirements of the first three prongs (as outlined below), with the requirements of Rule 15Fh-4(b) if the SBS Dealer's recommendation to a special entity would cause it to be acting as an advisor to the special entity.[521] The Commission is not making this change because the rules impose independent requirements, and the Commission believes that SBS Dealers should comply with each rule to the extent applicable.

The proposed special entity suitability alternative would have provided that an SBS Dealer would be deemed to satisfy its suitability obligations with respect to a special entity counterparty if the SBS Dealer either (1) is acting as an advisor to the special entity and complies with proposed Rule 15Fh-4(b), or (2) is deemed not to be acting as an advisor to the special entity pursuant to proposed Rule 15Fh-2(a).[522] With respect to the former, the Commission believes that when an SBS Dealer is acting as an advisor to a special entity, it is appropriate for both the best interests requirements of Rule 15Fh-4(b) and the suitability requirements of Rule 15Fh-3(f) to apply. As discussed in Section II.H.3 below, there is some overlap between the requirements, so an SBS Dealer's efforts to satisfy one set of requirements may result in satisfaction of the other. With respect to the latter, the Commission continues to believe, as noted in the Proposing Release, that the standards for determining that an SBS Dealer is not acting as an advisor under Rule 15Fh-2(a) are substantially the same as the standards that an SBS Dealer must satisfy to

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521 See SIFMA (August 2015), supra note 5. As discussed in Section II.H.2 below, Rule 15Fh-4(b) generally requires an SBS Dealer that acts as an advisor to a special entity 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.

522 See proposed Rule 15Fh-3(f)(3).

qualify for the institutional suitability alternative under Rule 15Fh-3(f)(2) (with the exception of the new institutional counterparty limitation described above).[523] However, the Commission agrees with the commenter that having a single institutional suitability alternative more consistent with the CFTC's rule will result in efficiencies and a lower likelihood of counterparty confusion.[524] Additionally, as we note above, the rules being adopted today are intended to provide certain protections for counterparties, including certain heightened protections for special entities. In this regard, we believe it is important that the rules impose both sets of requirements on SBS Dealers that make recommendations to special entities so that special entities receive the full range of benefits that the rules are intended to provide.

Fourth, the Commission is adding the words "with regard to the relevant security-based swap or trading strategy involving a security-based swap" to modify "recommendations of the [SBS Dealer]" in the second prong of the institutional suitability alternative to match the language used in the first prong and clarify that those are the only recommendations to which the rule refers. The Commission is adopting the other two prongs of the institutional suitability alternative as proposed. Accordingly, as adopted, Rule 15Fh-3(f)(2) provides that when an SBS Dealer makes a recommendation, it may fulfill its customer-specific suitability obligations under Rule 15Fh-3(f)(1)(ii) with respect to an institutional counterparty, if: (1) the SBS Dealer reasonably determines that the counterparty (or its agent) is capable of independently evaluating investment risks

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523 See Proposing Release, 76 FR at 42416 n.137, supra note 3.

524 See SIFMA (August 2015), supra note 5. However, as noted above, the CFTC does not limit the availability of its alternative to recommendations to "institutional counterparties." See Commodity Exchange Act Rule 23.434(b). The "institutional counterparty" limitation is discussed above.

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 of the SBS Dealer with regard to the relevant security-based swap or trading strategy involving a security-based swap; 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 for the counterparty. If an SBS Dealer cannot rely on the institutional suitability alternative provided by Rule15Fh-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.

The Commission believes that the SBS Dealer 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 for purposes of Rule 15Fh-3(f)(2)(i) through a variety of means. However, in response to specific suggestions from a commenter[525] and to provide additional clarity, the Commission is adding a safe harbor in Rule 15Fh-3(f)(3) providing that an SBS Dealer can satisfy its requirement under the first prong of the institutional suitability alternative in Rule 15Fh-3(f)(2) to make a reasonable determination that the counterparty (or its agent) is capable of independently evaluating investment risks with regard to the relevant security-based swap or trading strategy if the SBS Dealer receives appropriate written representations from its counterparty. As discussed above in Section II.D, an SBS Dealer can rely on a counterparty's written representations unless the SBS Dealer has information that would

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525 See SIFMA (August 2015), supra note 5.

cause a reasonable person to question the accuracy of the representation. Under Rule 15Fh-3(f)(3)(i),if the counterparty is not a special entity, the representations must provide that the counterparty has complied in good faith with written policies and procedures reasonably designed to ensure that the persons evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so. Under Rule 15Fh-3(f)(3)(ii), if the counterparty is a special entity, the representations must satisfy the terms of the safe harbor in Rule 15Fh-5(b).[526] If an SBS Dealer chooses not to take advantage of the safe harbor provided by Rule 15Fh-3(f)(3), the Commission believes that the SBS Dealer 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 for purposes of Rule 15Fh-3(f)(2)(i) through a variety of means. For example, an SBS Dealer could comply with this requirement by having a counterparty indicate in a signed agreement or other document that the counterparty is capable of independently evaluating investment risks with respect to recommendations or an SBS Dealer could call its counterparty, have that discussion, and (if it chooses or circumstances require) document the conversation to evidence the counterparty's affirmative indication.

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[526] As discussed in Section II.H.6.i below, Rule 15Fh-5(b) provides a safe harbor under which an SBS Entity can comply with its obligation to have a reasonable basis to believe that its special entity counterparty has a qualified independent representative that, among other things, has sufficient knowledge to evaluate the transaction and risks and undertakes to act in the best interests of the special entity. Rule 15Fh-5(b) specifies the representations that the SBS Entity must obtain from its special entity counterparty and, in some cases, from such counterparty's representative, to satisfy the safe harbor.

The Commission continues to believe that parties should be able to make the disclosures and representations required by Rules 15Fh-3(f)(2) and (3) on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or broadly in terms of all potential transactions between the parties.[527] However, where there is an indication that a counterparty is not capable of independently evaluating investment risks, or does not intend to exercise independent judgment regarding, all of an SBS Dealer's recommendations, the SBS Dealer necessarily will have to be more specific in its approach to complying with the institutional suitability alternative. For instance, in some cases an SBS Dealer may be unable to determine that a counterparty is capable of independently evaluating investment risks with respect to any security-based swap. In other cases, the SBS Dealer may determine that a counterparty is generally capable of evaluating investment risks with respect to some categories or types of security-based swaps, but that the counterparty may not be able to understand a particular type of security-based swap or its risk. Additionally, the requirements of Rule 15Fh-1(b) will apply when an SBS Dealer is relying on representations from a counterparty or its representative.[528]

We are not adopting one commenter's suggestions to require SBS Dealers to conduct routine audits to ensure that the institutional suitability alternative is used appropriately.[529] The Commission does not believe that routine audits are the sole means through which an SBS Dealer could supervise its associated persons' use of the

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527 See Proposing Release, 76 FR at 42416, supra note 3.

528 See discussion in Section II.D, supra.

529 See Levin, supra note 5.

institutional suitability alternative. The Commission thinks that the totality of the supervisory requirements in Rule 15Fh-3(h) (discussed below) are appropriate to promote effective supervisory systems and believes that SBS Dealers should have the flexibility to determine what means they will use to supervise their associated persons' use of the institutional suitability alternative. The Commission notes that in supervising the use of the institutional suitability alternative, SBS Dealers should generally consider whether their associated persons' reliance on representations from counterparties is reasonable. As discussed above and in Section II.D, an SBS Dealer (or its associated person) can rely on a counterparty's written representations unless the SBS Dealer has information that would cause a reasonable person to question the accuracy of the representation. In this context, information that might be relevant to this determination includes whether the counterparty has previously invested in the type of security-based swap or been involved in the type of trading strategy that the SBS Dealer is now recommending, and whether the counterparty (or its representative) appreciates what differentiates the recommended security-based swap from a less complex alternative. If the associated person knows that the recommended security-based swap or trading strategy represents a significant change from the counterparty's prior investment strategy or knows that the counterparty (or its representative) lacks an appreciation of what differentiates the recommended security-based swap from a less complex alternative, the associated person should generally consider whether it can reasonably rely on the counterparty's representation that it is capable of independently evaluating the investment risks.[530]

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[530] As discussed in Section II.D, under Rule 15Fh-1(b), an SBS Dealer can reasonably rely on written representations from a counterparty or its

The Commission is also not adopting another commenter's suggestion to add a requirement to the institutional suitability alternative that an SBS Dealer have a reasonable basis to believe its counterparty has the capacity to absorb potential losses related to the recommended security-based swap or trading strategy.[531] The Commission believes that the requirement in Rule 15Fh-3(f)(2)(i) that an SBS Dealer "have a reasonable basis to believe" that the counterparty is capable of evaluating investment risks independently is appropriate to support the objectives of the institutional suitability alternative, and does not believe it is necessary to specifically require an SBS Dealer to have a reasonable basis to believe its counterparty has the capacity to absorb potential losses related to the recommended security-based swap or trading strategy.

5. Fair and Balanced Communications

Section 15F(h)(3)(C) of the Exchange Act requires the Commission to adopt rules establishing a duty for SBS Entities to communicate in a fair and balanced manner based on principles of fair dealing and good faith.[532]

a. Proposed Rule

Proposed Rule 15Fh-3(g) would require SBS Entities to communicate with counterparties in a fair and balanced manner based upon principles of fair dealing and good faith. In particular, the rule would require: (1) communications to provide a sound

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representative to satisfy its due diligence obligations. Because reliance must be reasonable, the question of whether reliance on representations would satisfy an SBS Dealer's obligations under our business conduct rules will depend on the facts and circumstances of the particular matter. At a minimum, an SBS Dealer seeking to rely on representations cannot ignore information that would cause a reasonable person to question the accuracy of those representations.

531 See CFA, supra note 5.

532 15 U.S.C. 78o-10(h)(3)(C).

basis for evaluating the facts with regard to any particular security-based swap or trading strategy involving a security-based swap; (2) communications not to 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 to be balanced by an equally detailed statement of the corresponding risks.[533]

b. Comments on the Proposed Rule

Three commenters addressed the fair and balanced communications requirement.[534] Two commenters expressed support for the proposed rule,[535] and one was opposed.[536] One of the commenters supporting the proposed rule stated that there should not be any exceptions to the proposed fair and balanced communications requirement.[537] The other commenter asserted that to be fair and balanced, communications must inform investors of both the potential rewards and risks of their investments, and also the SBS Entity's involvement and interests in the investments, in specific terms.[538] Specifically, the commenter noted that all material adverse interests should be disclosed, and that the rule should clarify that it is not enough to inform a customer that the SBS Entity "may" have an adverse interest if that adverse interest

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533 Proposed Rule 15Fh-3(g)(1)-(3).

534 See CFA, supra note 5; Levin, supra note 5; AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5.

535 See CFA, supra note 5; Levin, supra note 5.

536 See AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5.

537 See CFA, supra note 5.

538 See Levin, supra note 5.

already exists.[539]

The commenter in opposition to the proposed rule asserted that a fair and balanced communications requirement is unnecessary.[540] The commenter explained that the proposed rule is not relevant in the context of SBS Entities' legacy portfolios since the proposed rule would generally prohibit puffery used to induce a counterparty to enter into new transactions.[541] Additionally, the commenter noted that due to the sophisticated nature of counterparties in the security-based swaps market, the fair and balanced communications requirement is not critical, particularly where all SBS Entities' communications are already subject to the antifraud provisions of the Dodd-Frank Act and the Exchange Act.[542]

c. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-3(g) as proposed. The rule applies in connection with entering into security-based swaps, and will continue to apply over the term of a security-based swap.[543]

The Commission does not believe any changes to the rule are necessary to address a commenter's concern that to be fair and balanced, communications must inform investors of both the potential rewards and risks of their investments because Rule 15Fh-3(g)(3) already provides that "[a]ny statement referring to the potential opportunities or

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539 Id.

540 See AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5.

541 See AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5.

542 See AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5.

543 See Rule 15Fh-1(a). In response to concerns expressed by a commenter, the Commission notes that there are no exceptions to Rule 15Fh-3(g). See CFA, supra note 5.

advantages presented by a security-based swap shall be balanced by an equally detailed statement of the corresponding risks."[544] With respect to the commenter's assertion that fair and balanced communications should also include information regarding the SBS Entity's involvement and interests in the investments,[545] the Commission notes that although specific disclosure regarding conflicts of interest is not required by Rule 15Fh-3(g), it is required by Rule 15Fh-3(b)(2) (disclosure of material incentives or conflicts of interest).

The standard set forth in Rule 15Fh-3(g) is consistent with the similarly worded requirement in the FINRA rule on communications.[546] Rule 15Fh-3(g) also includes three specific standards, drawn from the FINRA rule, which should clarify the rule requirement. The standards are: (1) 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;[547] (2) communications may not imply that past performance will recur, or make any exaggerated or unwarranted claim, opinion, or forecast;[548] and (3) any

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544 See Levin, supra note 5.

545 Id.

546 FINRA Rule 2210(d). See NASD 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.").

547 Cf. FINRA 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.").

548 Cf. FINRA Rule 2210(d)(1)(F) ("Communications may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast.").

statement referring to the potential opportunities or advantages presented by a security-based swap or trading strategy involving a security-based swap shall be balanced by an equally detailed statement of the corresponding risks.[549] As noted in the Proposing Release, these standards do not represent an exclusive list of considerations that an SBS Entity must take into account in determining whether a communication with a counterparty is fair and balanced.[550] In addition to complying with Rule 15Fh-3(g), SBS Entities should also keep in mind that all their communications with counterparties will be subject to the specific antifraud provisions added to the Exchange Act under Title VII of the Dodd-Frank Act,[551] as well as general antifraud provisions under the federal securities laws.[552] The Commission declines to eliminate the fair and balanced communications requirement, as suggested by a commenter,[553] because we believe the requirement promotes investor protection by prohibiting SBS Entities from overstating

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549 Cf. FINRA Rule 2210(d)(1)(D) ("Members must ensure that statements are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits. Communications must be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent to investments.") The Commission believes that this requirement addresses concerns raised by a commenter that to be fair and balanced, communications must inform investors of both the potential rewards and risks of their investments. See Levin, supra note 5.

550 See Proposing Release, 76 FR at 42418, supra note 3.

551 See Sections 9(j) and 15F(h)(4)(A) of the Exchange Act, 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 antifraud prohibitions of Section 9(j) of the Exchange Act).

552 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.

553 See AFGI (September 2012), supra note 5; AFGI (July 2013), supra note 5.

the benefits or understating the risks to inappropriately influence counterparties' investment decisions.

6. Obligation Regarding Diligent Supervision

Section 15F(h)(1)(B) of the Exchange Act authorizes the Commission to adopt rules for the diligent supervision of the business of SBS Entities.[554]

a. Proposed Rule

Proposed Rule 15Fh-3(h)(1) would require an SBS Entity to establish, maintain and enforce a system to supervise, and to diligently supervise, its business and associated persons, with a view to preventing violations of applicable federal securities laws, rules and regulations relating to its business as an SBS Entity. Proposed Rule 15Fh-3(h)(2) would require an SBS Entity's supervisory system to be reasonably designed to achieve compliance with applicable securities laws, rules and regulations, and would establish minimum requirements for the supervisory system. Specifically, proposed Rule 15Fh-3(h)(2)(i) would require an SBS Entity to designate at least one person with authority to carry out the supervisory responsibilities of the SBS Entity for each type of business in which it engages for which registration as an SBS Entity is required. Proposed Rule 15Fh-3(h)(2)(ii) would require an SBS Entity to use 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 SBS Entity.

Proposed Rule 15Fh-3(h)(2)(iii) would require an SBS Entity to establish, maintain and enforce written policies and procedures addressing the supervision of the

[554] 15 U.S.C. 78o-10(h)(1)(B).

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, rules and regulations,[555] and include, at a minimum: (1) procedures for the review by a supervisor of transactions for which registration as an SBS Entity is required;[556] (2) procedures for the review by a supervisor of incoming and outgoing written (including electronic) correspondence with counterparties or potential counterparties and internal written communications relating to the SBS Entity's business involving security-based swaps;[557] (3) procedures for a periodic review, at least annually, of the security-based swap business in which the SBS Entity engages that is reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable federal securities laws and regulations;[558] (4) 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 SBS Entity;[559] (5) 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 SBS Dealer, broker, dealer, investment adviser, or other financial institution, and if permitted, procedures to supervise the trading in such account, including the receipt of duplicate confirmations and statements related to such account;[560]

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555 Proposed Rule 15Fh-3(h)(2)(iii).

556 Proposed Rule 15Fh-3(h)(2)(iii)(A).

557 Proposed Rule 15Fh-3(h)(2)(iii)(B).

558 Proposed Rule 15Fh-3(h)(2)(iii)(C).

559 Proposed Rule 15Fh-3(h)(2)(iii)(D).

560 Proposed Rule 15Fh-3(h)(2)(iii)(E).

(6) 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 SBS Entity is engaged;[561] (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;[562] and (8) 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.[563] Additionally, proposed Rule 15Fh-3(h)(2)(iv) would require an SBS Entity to include written policies and procedures reasonably designed, taking into consideration the nature of the SBS Entity's business, to comply with the duties set forth in Section 15F(j) of the Exchange Act.[564]

Under proposed Rule 15Fh-3(h)(3), the Commission proposed two mechanisms under which an SBS Entity or associated person would not be deemed to have failed to diligently supervise any other person. The SBS Entity or associated person could demonstrate that: (1) such person is not subject to his or her supervision, or (2) it meets the terms of a safe harbor. The safe harbor would require the SBS Entity or associated person to satisfy two conditions. The first condition would be that 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

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561 Proposed Rule 15Fh-3(h)(2)(iii)(F).

562 Proposed Rule 15Fh-3(h)(2)(iii)(G).

563 Proposed Rule 15Fh-3(h)(2)(iii)(H).

564 See 15 U.S.C. 78o-10(j).

regulations thereunder relating to security-based swaps.[565] The second condition would be that the SBS Entity or associated person has reasonably discharged the duties and obligations required by such written policies and procedures and documented system and did not have a reasonable basis to believe that such written policies and procedures and documented system were not being followed.[566]

Finally, proposed Rule 15Fh-3(h)(4) would require an SBS Entity to promptly amend its written supervisory procedures as appropriate when material changes occur in either applicable securities laws, rules or regulations, or in the SBS Entity's business or supervisory system, and to promptly communicate any material amendments to its supervisory procedures throughout the relevant parts of its organization.

b. Comments on the Proposed Rule

Five commenters addressed the proposed supervision rule.[567] One commenter supported the requirement in proposed Rule 15Fh-3(h)(2)(iv) that SBS Entities adopt written policies and procedures reasonably designed to ensure compliance with the duties set forth in Section 15F(j) of the Exchange Act.[568] The commenter noted that this approach, which does not mandate the inclusion of specific elements or prohibitions, will provide SBS Entities flexibility in establishing compliance policies appropriate for their management and organizational structure.[569]

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565 Proposed Rule 15Fh-3(h)(3)(i).

566 Proposed Rule 15Fh-3(h)(3)(ii).

567 See CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; MFA, supra note 5; NABL, supra note 5; SIFMA (September 2015), supra note 5.

568 See NABL, supra note 5.

569 Id.

Another commenter argued for additional diligent supervision requirements.[570] The commenter recommended requiring supervisory personnel to report to upper management or the board, as appropriate, if they have reason to believe the SBS Entity's supervisory procedures are not proving effective in preventing violations.[571] The commenter also suggested requiring SBS Entities to reevaluate their supervisory procedures when they fail to detect or deter significant violations, and determine whether revisions are needed.[572]

In contrast, a third commenter requested that the Commission narrow the proposed supervision requirements.[573] The commenter suggested that the Commission clarify that when an SBS Entity is already subject to, and complies with, comparable requirements of another "qualifying regulator" (such as risk management standards imposed by a prudential regulator), the SBS Entity's supervisory policies and procedures will be deemed to be reasonably designed for purposes of the proposed rule.[574] The commenter also requested that the Commission clarify that a person committing a violation will not be viewed as being subject to the supervision of another person unless the putative supervisor knew or should have known that he or she had the authority and responsibility to exercise control over the other person that could have prevented the violation.[575]

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570 See CFA, supra note 5.

571 Id.

572 Id.

573 See FIA/ISDA/SIFMA, supra note 5.

574 Id.

575 Id.

A fourth commenter opposed the application of the proposed rule to Major SBS Participants.[576] The commenter asserted that the proposed rule imposes burdensome and costly supervisory procedures on Major SBS Participants that are not appropriate given their non-dealer role in the marketplace, and that the potential costs of compliance would be without any meaningful offsetting benefit for other market participants or the financial markets as a whole.[577]

A fifth commenter recommended harmonizing the Commission's supervision requirements with FINRA Rule 3110 to enable SBS Entities that are also broker-dealers to make use of their existing supervisory systems and to minimize confusion.[578] Specifically, the commenter suggested eliminating the proposed requirements in proposed Rule 15Fh-3(h)(1) to "enforce" a system to supervise and to diligently supervise "the business" (as opposed to the associated persons) of the SBS Entity, and changing the description of the supervisory system from "with a view to preventing violations of" to "reasonably designed to ensure compliance with" the provisions of applicable federal securities laws and the rules and regulations thereunder relating to its business as an SBS Entity.[579] The commenter also recommended eliminating the

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576 See MFA, supra note 5.

577 Id.

578 See SIFMA (September 2015), supra note 5. Although the Commission modeled proposed Rule 15Fh-3(h) in part on NASD Rules 3010 (Supervision) and 3012 (Supervisory Control System), the Commission subsequently approved new consolidated FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System), which are largely based on and replace NASD Rules 3010 and 3012, and corresponding provisions of the NYSE Rules and Interpretations. See Order Approving Proposed Rule Change as Modified by Amendment No. 1, Exchange Act Release No. 71179 (Dec. 23, 2013), 78 FR 79542 (Dec. 30, 2013).

579 Id.

redundant description of the supervisory system in proposed Rule 15Fh-3(h)(2), and making a number of changes to the wording of the minimum requirements listed in sub-section (h)(2) to align them with FINRA Rule 3110.[580] The commenter also asked that the Commission modify the rule text to reflect that security-based swaps are not necessarily traded in an "account" but rather pursuant to a bilateral trading relationship.[581] Additionally, the commenter recommended adding a provision allowing an SBS Entity that cannot comply with the requirement in proposed Rule 15Fh-3(h)(2)(iii)(G) (preventing a supervisor from supervising his or her own activities or reporting to a person he or she is supervising) to document its determination that compliance is not possible because of the firm's size or a supervisory person's position within the firm and document how the supervisory arrangement otherwise complies with proposed Rule 15Fh-3(h)(1).[582] The commenter also requested that the Commission provide guidance regarding risk-based reviews that is consistent with FINRA supplementary material on the topic.[583] Finally, the commenter recommended wording changes to the maintenance of written supervisory procedures requirement in proposed Rule 15Fh-3(h)(4) to harmonize with FINRA Rule 3110, including eliminating the proposed requirement to update the written supervisory procedures when material changes occur to the "business," as opposed to the supervisory system.[584]

c. <u>Response to Comments and Final Rule</u>

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580 Id.

581 Id.

582 Id.

583 Id.

584 Id.

After considering the comments, the Commission is adopting Rule 15Fh-3(h) with certain modifications. In response to commenters' concerns regarding SBS Entities that will also be registered as broker-dealers or Swap Entities being subject to overlapping requirements with respect to their supervisory systems,[585] the modifications (discussed below) are primarily intended to make the final rule more consistent with FINRA Rule 3110 and the CFTC's supervision rule for Swap Entities while continuing to provide protections intended to help ensure that SBS Entities have effective supervisory systems.[586] While, as discussed throughout this release, we are making changes to many of the business conduct rules that are intended to make the final rules more consistent with the parallel CFTC requirements, for the supervision and CCO rules, in particular, we agree with a commenter that consistency with the parallel FINRA rules is also important because many SBS Entities have already established infrastructure to comply with those rules in the context of broader supervisory and compliance programs across their

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585 See SIFMA (September 2015), supra note 5; FIA/ISDA/SIFMA, supra note 5.

586 As noted above, although the Commission modeled proposed Rule 15Fh-3(h) in part on NASD Rules 3010 (Supervision) and 3012 (Supervisory Control System), the Commission subsequently approved new consolidated FINRA Rules 3110 (Supervision) and 3120 (Supervisory Control System), which are largely based on and replace NASD Rules 3010 and 3012, and corresponding provisions of the NYSE Rules and Interpretations. Among other changes to the rules, the new FINRA rules contain new or modified requirements with respect to: (i) which personnel can supervise other personnel; (ii) which personnel are permitted to perform office inspections; (iii) review of certain internal communications; and (iv) obligations to monitor for insider trading, conduct internal investigations and provide reports to FINRA regarding such investigations. The new FINRA rule also codified guidance regarding the permissible use of risk-based systems for review of transactions and correspondence. See Order Approving Proposed Rule Change as Modified by Amendment No. 1, Exchange Act Release No. 71179 (Dec. 23, 2013), 78 FR 79542 (Dec. 30, 2013).

security-based swap and related securities and swaps businesses.[587] This consistency will result in efficiencies for SBS Entities that have already established supervisory systems to comply with the FINRA and/or CFTC standards. Consistent wording will also allow SBS Entities to more easily analyze compliance with the Commission's rule against their existing activities to comply with FINRA Rule 3110 and the CFTC's supervision rule for Swap Entities.

First, in response to a specific suggestion made by a commenter,[588] the Commission is making several wording changes to the description of the general requirement to establish a supervisory system in Rule 15Fh-3(h)(1). The Commission is deleting the words "and enforce" from the description and adding the modifying language "the activities of" before associated persons so that it requires an SBS Entity to "establish and maintain a system to supervise, and [to] diligently supervise, its business and the activities of its associated persons."[589] Rule 15Fh-3(h)(2)(iii) (discussed below) includes an express requirement to enforce supervisory policies and procedures, making the additional language regarding enforcing the system to supervise unnecessary. Accordingly, the Commission believes that the rule, as adopted with these wording changes, will continue to establish requirements to help ensure that SBS Entities have effective supervisory systems, consistent with the proposed rule. At the same time, the

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587 See SIFMA (September 2015), supra note 5.

588 See SIFMA (September 2015), supra note 5.

589 Cf. FINRA Rule 3110(a) ("Each member shall establish and maintain a system to supervise the activities of each associated person..."); Commodity Exchange Act Rule 23.602(a) ("Each [Swap Entity] shall establish and maintain a system to supervise, and shall diligently supervise, all activities relating to its business performed by its partners, members, officers, employees, and agents (or persons occupying a similar status or performing a similar function)…").

changes will make the wording of the rule more consistent with the corresponding FINRA and CFTC requirements, as requested by a commenter. This consistency will result in efficiencies for SBS Entities that have already established supervisory systems to comply with the FINRA and/or CFTC standards, as discussed above.

Second, the Commission is making further wording changes to the descriptions of the required supervisory system in Rule 15Fh-3(h)(1) and (2) in response to concerns raised by a commenter regarding the redundancy of the descriptions.[590] Proposed Rule 15Fh-3(h)(1) would require SBS Entities to "establish…a system to supervise…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 an SBS Entity]," and proposed Rule 15Fh-3(h)(2) would specify that the required system be "reasonably designed to achieve compliance with applicable securities laws and the rules and regulations thereunder." The Commission does not believe that the two descriptions ("prevent violations" and "achieve compliance") are substantively different, nor did we intend to give the appearance of creating two different standards for what is essentially the same requirement. Accordingly, the Commission is changing and consolidating the description of the supervisory system in Rule 15Fh-3(h)(1) to state that an SBS Entity's supervisory system "shall be reasonably designed to prevent violations of applicable federal securities laws and the rules and regulations thereunder relating to its business [as an SBS Entity]," and eliminating the redundant description in Rule 15Fh-3(h)(2).[591]

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590 See SIFMA (September 2015), supra note 5.

591 This formulation tracks the requirement in Exchange Act Rule 15Fb2-1(b) that a senior officer of the SBS Entity certify on Form SBSE–C that "[a]fter due inquiry, he or she has reasonably determined that the [SBS Entity] has developed and

Additionally, the Commission is making parallel changes to Rules 15Fh-3(h)(2)(iii) and 15Fh-3(h)(2)(iii)(C). Specifically, the Commission is changing the requirement in Rule 15Fh-3(h)(2)(iii) that the supervisory system provide for the establishment, maintenance and enforcement of certain written policies and procedures from policies and procedures that are "reasonably designed to achieve compliance with" to policies and procedures that are "reasonably designed to prevent violations of applicable federal securities laws and the rules and regulations thereunder." The Commission is also changing the requirement in Rule 15Fh-3(h)(2)(iii)(C) that an SBS Entity's supervisory policies and procedures include procedures for a periodic review of the SBS Entity's security-based swap business by eliminating the redundant requirement that the review be reasonably designed to assist in "achieving compliance with" applicable federal securities laws and regulations and conforming the remaining language. Accordingly, as adopted, Rule 15Fh-3(h)(2)(iii)(C) requires an SBS Entity's written supervisory policies and procedures to include "[p]rocedures for a periodic review, at least annually, of the security-based swap business in which the [SBS Entity] engages that is reasonably designed to assist in detecting and preventing violations of applicable federal securities laws and the rules and regulations thereunder."

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implemented written policies and procedures reasonably designed to prevent violation of federal securities laws and the rules thereunder." Cf. FINRA Rule 3110(a) ("Each member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules."); Commodity Exchange Act Rule 23.602(a) ("Each [Swap Entity] shall establish and maintain a system to supervise...Such system shall be reasonably designed to achieve compliance with the requirements of the Commodity Exchange Act and [CFTC] regulations.").

Third, in response to concerns raised by a commenter,[592] the Commission is changing the wording of the minimum requirements for a supervisory system listed in Rule 15Fh-3(h)(2) to more closely align the requirements of our rule with those of FINRA Rule 3110, and to reflect the fact that security-based swaps are not necessarily traded in an "account" but rather pursuant to a bilateral trading relationship. Specifically, the Commission is: (1) changing the description of the requirement that supervisors be qualified in Rule 15Fh-3(h)(2)(ii) from "qualified and meet standards of training, experience, and competence necessary to effectively supervise the security-based swap activities of the persons associated with the [SBS Entity]" to "qualified, either by virtue of experience or training, to carry out their assigned responsibilities;"[593] (2) adding "and the activities of its associated persons" to the policies and procedures requirement in Rule 15Fh-3(h)(2)(iii) so that it requires "written policies and procedures addressing the supervision of the types of security-based swap business in which the [SBS Entity] is engaged and the activities of its associated persons;"[594] (3) adding "good" to the description of the requirement to have procedures for background investigations on associated persons in Rule 15Fh-3(h)(2)(iii)(D) so that it requires "procedures to conduct

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592 See SIFMA (September 2015), supra note 5.

593 Cf. FINRA Rule 3110(a)(6) ("A member's supervisory system shall provide…for…[t]he use of reasonable efforts to determine that all supervisory personnel are qualified, either by virtue of experience or training, to carry out their assigned responsibilities.").

594 Cf. FINRA Rule 3110(b)(1) ("Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons…").

a reasonable investigation regarding the good character" of an associated person;[595] (4) adding "or a trading relationship" to the description of the requirement to have procedures for considering whether to allow an associated person to conduct trading for his or her own benefit at another financial institution in Rule 15Fh-3(h)(2)(iii)(E) so that it requires "procedures to consider whether to permit an associated person to establish or maintain a securities or commodities account or a trading relationship;" and (5) changing the description of the requirement to have conflicts of interest procedures in Rule 15Fh-3(h)(2)(iii)(H) from "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" to "procedures reasonably designed to prevent the supervisory system required by paragraph (h)(1) from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the [SBS Entity], or any compensation that the associated person conducting the supervision may derive from the associated person being supervised."[596] The Commission believes that the rule, as adopted with these changes, will continue to provide protections intended to

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595 Cf. FINRA Rule 3110(e) ("Each member shall ascertain by investigation the good character…of an applicant before the member applies to register that applicant with FINRA...").

596 Cf. FINRA Rule 3110(b)(6)(D) ("The supervisory procedures…shall include…procedures reasonably designed to prevent the supervisory system required pursuant to paragraph (a) of this Rule from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the firm, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised, including the position of such person, the revenue such person generates for the firm, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised.").

help ensure that SBS Entities have effective supervisory systems, consistent with the proposed rule. At the same time, the changes will make the wording of the rule more consistent with the parallel FINRA requirement, resulting in efficiencies for SBS Entities that have already established supervisory systems to comply with the FINRA standard, as discussed above.

In addition to the wording changes described above, the Commission is making two other sets of changes to the minimum requirements for a supervisory system listed in Rule 15Fh-3(h)(2). First, the Commission is eliminating the specific requirement in proposed Rule 15Fh-3(h)(2)(iii)(E) that the supervision of trading in an associated person's securities or commodities account at another financial institution "includ[e] the receipt of duplicate confirmations and statements related to such accounts." This change is intended to more closely align our requirement with the analogous FINRA rule, which was amended after our proposal.[597] The amended FINRA rule replaced the requirement to receive duplicate confirmation and statements with a more flexible standard by which firms can determine the data source(s) that are the most effective means to review trading activity. Likewise, this change is also intended to provide SBS Entities reasonable flexibility to craft appropriate supervisory policies and procedures relevant to their business model and to ascertain the means to obtain the necessary data for effective

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[597] See Order Approving Proposed Rule Change to Adopt FINRA Rule 3210 (Accounts at Other Broker-Dealers and Financial Institutions), as Modified by Partial Amendment No. 1 and Partial Amendment No. 2, in the Consolidated FINRA Rulebook, Exchange Act Release No. 77550 (Apr. 7, 2016), 81 FR 21924 (Apr. 13, 2016) ("Proposed FINRA Rule 3210(c) would require an executing member, upon written request by the employer member, to transmit duplicate copies of confirmations and statements, or the transactional data contained therein, with respect to an account subject to the rule.").

supervision. The Commission notes that the rule, in permitting flexibility, does not limit the SBS Entity's discretion to request from the associated person such transaction and account information as the SBS Entity deems necessary to fulfill its supervisory obligations (including confirmations and statements related to the account or trading relationship), and SBS Entities may consider the availability of such information and whether activity in the account can be properly monitored when determining whether to provide consent to an associated person to open or maintain an account or trading relationship at another financial institution.

Second, in response to concerns raised by a commenter,[598] the Commission is modifying Rule 15Fh-3(h)(2)(iii)(G) to address circumstances where an SBS Entity is unable to comply with the supervisory requirements due to the SBS Entity's size or supervisor's position within the SBS Entity. Pursuant to final Rule 15Fh-3(h)(2)(iii)(G), an SBS Entity that cannot comply with the requirement in Rule 15Fh-3(h)(2)(iii)(G) (preventing a supervisor from supervising his or her own activities or reporting to a person he or she is supervising) will be required to document its determination that compliance is not possible because of the firm's size or a supervisory person's position within the firm, document how the supervisory arrangement otherwise complies with Rule 15Fh-3(h)(1), and include a summary of such determination in the annual compliance report prepared by the SBS Entity's CCO pursuant to Rule 15Fk-1(c). This change is designed to address concerns raised by a commenter that due to the size or structure of some SBS Entities, it may not always be possible to prohibit an associated person who performs a supervisory function at an SBS Entity from supervising his or her

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598 See SIFMA (September 2015), supra note 5.

own activities or reporting to a person whom he or she is supervising.[599] The Commission believes adding the provision described above will make the supervisory requirements more operationally workable by providing flexibility, in particular for supervision of very senior SBS Entity personnel, while still maintaining appropriate investor protection through the requirement to document how the supervisory arrangement otherwise complies with Rule 15Fh-3(h)(1). The Commission notes that SBS Entities relying on this provision will also be subject to the other requirements of Rule 15Fh-3(h), including the requirement in Rule 15Fh-3(h)(2)(iii)(H) to have procedures reasonably designed to prevent the supervisory system from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the SBS Entity, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised.

The Commission notes that the minimum requirements for a supervisory system listed in Rule 15Fh-3(h)(2) are not an exhaustive list. SBS Entities should keep in mind their overarching obligation in Rule 15Fh-3(h)(1) to establish and maintain a supervisory system that is reasonably designed to prevent violations of applicable federal securities laws and the rules and regulations thereunder relating to the SBS Entity's business as an SBS Entity. For instance, although Rule 15Fh-3(h)(2)(iii)(B) only requires procedures "for the review by a supervisor of incoming and outgoing written (including electronic) correspondence with counterparties or potential counterparties and internal written communications relating to the [SBS Entity's] business involving security-based swaps,"

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599 See SIFMA (September 2015), supra note 5.

if an SBS Entity records oral communications with counterparties or potential counterparties, the SBS Entity generally should consider providing for the supervisory review of such communications.[600] Similarly, if an SBS Entity chooses to provide certain disclosures required by Rule 15Fh-3(b) orally, the SBS Entity should consider how it will supervise these oral communications.

In response to a specific suggestion made by a commenter,[601] the Commission is modifying the maintenance of written supervisory procedures requirement in Rule 15Fh-3(h)(4) to harmonize with FINRA Rule 3110. Specifically, we are changing the requirement to promptly communicate material amendments to an SBS Entity's supervisory procedures from "throughout the relevant parts of its organization" to "to all associated persons to whom such amendments are relevant based on their activities and responsibilities."[602] We believe that the new formulation will be more effective at

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600 Section 15F(g)(1) of the Exchange Act provides that each SBS Entity shall maintain daily trading records of the security-based swaps of the SBS Entity 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. See 15 U.S.C. 78o–10(g)(1). To implement Section 15F(g)(1) of the Exchange Act, the Commission has proposed to amend the preservation requirement in paragraph (b)(4) of Exchange Act Rule 17a–4 to include ''recordings of telephone calls required to be maintained pursuant to [Section 15F(g)(1) of the Exchange Act].'' Under this proposed requirement, a broker-dealer SBS Entity would be required to preserve for three years telephone calls that it chooses to record to the extent the calls are required to be maintained pursuant to Section 15F(g)(1) of the Exchange Act. The Commission has also proposed a parallel requirement for stand-alone SBS Entities. See Recordkeeping Release, 79 FR at 25213-25214, supra note 242.

601 See SIFMA (September 2015), supra note 5.

602 Cf. FINRA Rule 3110(b)(7) ("Each member shall promptly amend its written supervisory procedures to reflect changes in applicable securities laws or regulations, including FINRA rules, and as changes occur in its supervisory system. Each member is responsible for promptly communicating its written

achieving its intended result by targeting the communications to the associated persons to whom such amendments are relevant. The Commission believes that under the proposed formulation, potential interpretations of the phrase "relevant parts of its organization" may have resulted in communications to a broader than necessary group. The Commission declines to adopt the commenter's suggestion to eliminate the proposed requirement in Rule 15Fh-3(h)(4)(i) for an SBS Entity to update its written supervisory procedures when material changes occur to its "business," in addition to its supervisory system.[603] Rule 15Fh-3(h)(1) requires an SBS Entity to diligently supervise its business. Implicit in that obligation is a requirement that the SBS Entity update its supervisory system as necessary to accommodate changes to its business. The Commission does not want to create confusion regarding this obligation by eliminating the explicit requirement in Rule 15Fh-3(h)(4)(i) for an SBS Entity to update its supervisory procedures when material changes occur to its business.

In addition to the modifications discussed above, the Commission is making several clarifying changes to the rule. First, the Commission is correcting a typographical error in Rule 15Fh-3(h)(2). The cross-reference in the proposed rule should have been to "paragraph (h)(1)," not to "paragraph (g)(1)." The Commission is correcting this cross-reference in the final rule.

Second, the Commission also is making two other changes to the rule to clarify that Rule 15Fh-3(h) does not require multiple sets of written supervisory policies and

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supervisory procedures and amendments to all associated persons to whom such written supervisory procedures and amendments are relevant based on their activities and responsibilities.").

603 See SIFMA (September 2015), supra note 5.

procedures. Specifically, the Commission is: (1) re-designating proposed Rule 15Fh-3(h)(2)(iv) as Rule 15Fh-3(h)(2)(iii)(I); and (2) clarifying that the written policies and procedures referred to in Rule 15Fh-3(h)(3) are those required by Rule 15Fh-3(h)(2)(iii) by adding the modifying language "as required in §240.15Fh-3(h)(2)(iii)" after "written policies and procedures" in Rule 15Fh-3(h)(3)(i), and by changing the references in Rule 15Fh-3(h)(3)(ii) from "the written policies and procedures" to "such written policies and procedures."

Rule 15Fh-3(h) establishes supervisory obligations that incorporate principles from both Exchange Act Section 15(b) and existing SRO rules. The concept of diligent supervision in these rules is consistent with business conduct standards for broker-dealers that have historically been established by SROs for their members, subject to Commission approval. As with diligent supervision by a broker-dealer, the Commission believes that it generally would be appropriate for an SBS Entity to use a risk-based review system to satisfy its supervisory obligations under Rule 15Fh-3(h) instead of conducting detailed reviews of every transaction or every communication, so long as the SBS Entity uses a risk-based review system that is reasonably designed to provide the entity with sufficient information to allow it to focus on the areas that pose the greatest risks of federal securities law violations.[604] Use of a risk-based system allows SBS Entities the flexibility to establish their supervisory systems in a manner that reflects their

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[604] This guidance is intended to respond to a request from a commenter to provide guidance regarding risk-based reviews that is consistent with Supplementary Material .05 and .06 to FINRA Rule 3110. See SIFMA (September 2015), supra note 5.

business models, and based on those models, focus on areas where heightened concern may be warranted.

Rule 15Fh-3(h)(2)(iii)(I), as adopted, requires 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. 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; 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.[605] While the requirements of Section 15F(j) are self-executing, we highlight in particular the duty of an SBS Entity under Section 15F(j)(2) to "establish robust and professional risk management systems adequate for managing the day-to-day business" of the SBS Entity. Any risk management system established by an SBS Entity should be effective to manage the risks of the SBS Entity within the risk tolerance limits to be determined for each type of risk. We have separately proposed a rule regarding the requirement for an SBS Entity for which there is not a prudential regulator to establish,

[605] 15 U.S.C. 78o-10(j).

document, and maintain controls to assist it in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks.[606]

We are not adopting a commenter's[607] suggestion that when an SBS Entity is already subject to, and complies with, comparable requirements of another "qualifying regulator" (such as risk management standards imposed by a prudential regulator), the SBS Entity's supervisory policies and procedures will be deemed to be reasonably designed for purposes of Rule 15Fh-3(h). Exchange Act Section 15F(h)(1)(B) directs the Commission to adopt rules relating to the diligent supervision of SBS Entities' business. Although we have closely conformed our supervision rule to parallel SRO requirements and believe it is also consistent with parallel CFTC requirements, we do not believe it is

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606 The Commission has separately proposed to require every SBS Entity for which there is not a prudential regulator ("Non-bank SBS Dealers") to comply, with certain exceptions, with the requirements of Rule 15c3-4 under the Exchange Act "as if it were an OTC derivatives dealer with respect to all of its business activities." See Exchange Act Rule 18a-1(g). See also Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70214, 70250-70251 (Nov. 23, 2012), explaining that application of Rule 15c3-4 would require a Non-bank SBS Entity to "establish, document, and maintain a system of internal risk management controls to assist in managing the risks associated with its business activities, including market, credit, leverage, liquidity, legal, and operational risks." Rule 15c3-4 identifies a number of elements that must be part of the risk management system including, among other things: a risk control unit that reports directly to senior management and is independent from business trading units; separation of duties between persons responsible for entering into a transaction and those responsible for recording the transaction on the dealer's books; and periodic reviews (which may be performed by internal audit staff) and annual reviews (which must be conducted by independent certified public accountants) of the dealer's risk management systems. Id.

607 See FIA/ISDA/SIFMA, supra note 5.

appropriate to defer to other regulators' rules, other than as discussed below in Section III. In addition, we are not excluding Major SBS Participants from the scope of the rule, as one commenter suggested.[608] We note that Exchange Act Section 15Fh(1)(B) explicitly contemplates that Major SBS Participants, as well as SBS Dealers, will have obligations to supervise diligently their security-based swap business. As discussed above in Section II.C, where the Dodd-Frank Act imposes a business conduct requirement on both SBS Dealers and Major SBS Participants, the rules will apply to both entities.

Rule 15Fh-3(h)(3), as adopted, provides that SBS Entities and associated persons will not be liable for failure to supervise another person if either the other person is not subject to the SBS Entity's or associated person's supervision, or if the safe harbor described in the rule is satisfied.[609] The safe harbor contains two conditions. 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 and regulations thereunder relating to security-based swaps. Second, the SBS Entity or associated 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

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608 See MFA, supra note 5.

609 One commenter requested clarification that a person committing a violation will not be viewed as subject to the supervision of another person unless such other person knew or should have known that he or she had authority and responsibility to exercise control over the violator that could have prevented the violation. See FIA/ISDA/SIFMA, supra note 5. The Commission notes that if the conditions of the safe harbor in Rule 15Fh-3(h)(3) are not met, liability for failure to supervise would be a facts and circumstances determination, which would take into account the factors described by the commenter.

such procedures were not being followed.[610] Both conditions must be met in order for an SBS Entity to satisfy the safe harbor. However, as noted in the Proposing Release, the inability to rely on the safe harbor would not necessarily mean that an SBS Entity or associated person failed to diligently supervise any other person.[611]

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610 We are not adopting a commenter's recommendation that our rules expressly require supervisory personnel to "report up" to upper management of the board, and require an SBS Entity to reevaluate its supervisory procedures if they fail to detect or deter significant violations. See CFA, supra note 5. We note that Rule 15Fh-3(h) provides a baseline for an effective supervisory system, but, as noted in the Proposing Release, a particular system may need additional elements to be effective. See Proposing Release, 76 FR at 42419, supra note 3. For that reason, Rule 15Fh-3(h)(2) states that it establishes only minimum requirements. Id.

611 See Proposing Release, 76 FR at 42420, supra note 3. With respect to broker-dealers, the Commission's policy regarding failure to supervise is well established. See 15 U.S.C. 78o(b)(4)(E) and 15 U.S.C. 78o(b)(6)(A). As the Commission has 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.
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> John H. Gutfreund, Exchange Act Release No. 31554 (Dec. 3, 1992) (report pursuant to Section 21(a) of the Exchange Act) (footnotes omitted). See Proposing Release, 76 FR at 42419 n.158, supra note 3.

H. Rules Applicable to Dealings with Special Entities

Sections 15F(h)(4) and (5) of the Exchange Act provide certain additional protections for "special entities" -- such as municipalities, federal and state agencies, pension plans, and endowments[612] -- in connection with security-based swaps.[613]

Special entities, like other market participants, may use swaps and security-based swaps for a variety of purposes, including risk management and portfolio adjustment. In adopting the special entity provisions of the Exchange Act, the Commission seeks to implement the statute, while not impeding special entities' access to security-based swaps.

1. Scope of Definition of "Special Entity"

a. Proposed Rule

Exchange Act Section 15F(h)(2)(C) defines a "special entity" as: (i) a Federal agency; (ii) a State, State agency, city, county, municipality, or other political subdivision of a State; (iii) any employee benefit plan, as defined in Section 3 of ERISA; (iv) any governmental plan, as defined in Section 3 of ERISA; or (v) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.[614] Proposed Rule 15Fh-2(e) defines a "special entity" as: (i) a

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612 See Section II.D.2.a, infra.

613 15U.S.C. 78o-10(h)(4)-(5).

614 Section 501(c)(3) of the Internal Revenue Code of 1986 includes, in its list of "exempt organizations":

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for

Federal agency; (ii) a State, State agency, city, county, municipality, or other political subdivision of a State; (iii) any employee benefit plan, as defined in Section 3 of ERISA; (iv) any governmental plan, as defined in Section 3(32) of ERISA; or (v) any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986.

The Proposing Release noted that commenters had raised questions about the scope of the "special entity" definition. The Commission requested comment regarding: (1) whether to interpret the phrase "employee benefit plan, as defined in Section 3" of ERISA to mean a plan that is subject to regulation under ERISA; (2) whether the phrase "governmental plan" should include government investment pools or other plans, programs or pools of assets; (3) the definition of the term "endowment;" (4) the treatment of collective investment vehicles in which one or more special entities are invested; (5) the treatment of foreign entities; and (6) the treatment of master trusts holding the assets of one or more funded plans of a single employer and its affiliates.

b. Comments on the Proposed Rule

One commenter argued that the term "special entity" was adequately defined in the Exchange Act, and that it "should not require extensive clarification."[615] However,

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> the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

26 U.S.C. 501(c)(3).

615 See CFA, supra note 5. See also Exchange Act Section 15F(h)(2)(C).

most commenters requested that the Commission exclude or include specific groups from the "special entity" designation. These comments are addressed below.

i. Federal Agency

We received no comments regarding the inclusion of federal agencies within the special entity definition. In the Proposing Release, we noted that 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."[616]

ii. State and Municipal Entities

One commenter suggested that we modify the description of state and municipal entities to include "any instrumentality, department, or a corporation of or established by a State or political subdivision of a State."[617] According to the commenter, this modification would harmonize the SEC's definition of "special entity" with that of the CFTC.[618]

iii. Employee Benefit Plans and Governmental Plans

As stated above, Exchange Act Section 15F(h)(2)(C)(iii) defines "special entity" to include "any employee benefit plan, as defined in Section 3 of [ERISA]."[619] Section 15F(h)(2)(C)(iv) separately adds "any governmental plan, as defined in Section 3 [ERISA]" to the special entity definition. Section 3 of ERISA defines the term

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616 Proposing Release, 76 FR 42421, n. 176, supra note 3 (citing Section 3(a)(68) of the Exchange Act).

617 See SIFMA (August 2015), supra note 5.

618 Id.

619 15 U.S.C. 78o-10(h)(2)(C)(iii).

"employee benefit plan" to include plans, such as most private sector employee benefit plans, that are subject to regulation under Title I of ERISA.[620] However, Section 3 of ERISA also defines the following additional categories of employee benefit plans that are not subject to" ERISA regulation: (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 of persons substantially all of whom are nonresident aliens; or (5) unfunded excess benefit plans.[621] These latter categories of employee benefit plans, including governmental plans, are therefore "defined in" ERISA, but not "subject to" regulation under ERISA.

Commenters asked the Commission at the proposing stage to limit the scope of Section 15F(h)(2)(C)(iii) to employee benefit plans that are subject to regulation under ERISA, and not to extend the definition of "special entity" to plans that are merely "defined in" ERISA, "unless they are covered by another applicable prong of the "special entity" definition (e.g., governmental plans)."[622] As the commenters noted, Exchange Act Section 15F(h)(2)(C)(iv) separately defines "special entity" to include any governmental plan, as defined in Section 3 of ERISA. Mindful of the redundancy that would result if the statute were interpreted to include governmental plans twice in the definition of "special entity," the Commission therefore requested comment regarding whether to interpret the phrase "employee benefit plan, as defined in Section 3 of

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620 See generally 29 U.S.C. 1002(1)-(2).

621 See 29 U.S.C. 1003(b).

622 SIFMA/ISDA 2010 Letter at 2, supra note 34.

[ERISA]" in Exchange Act Section 15F(h)(2)(C)(iii), or to mean a plan that is "subject to" regulation under ERISA.[623]

Seven comment letters addressed this issue. One commenter argued that the expansive language of the statute suggested that any employee benefit plan "defined in" ERISA, including a church plan, should be treated as a special entity, and that, as a matter of policy, church plans should not be treated differently than ERISA or governmental plans when entering into security-based swaps with SBS Entities.[624] This commenter recommended that the Commission revise the proposed special entity definition to clarify that church plans are special entities, or that the Commission permit church plans to "opt in" to special entity status, since opting in would provide potential counterparties greater certainty regarding whether a church plan was, in fact, a special entity.[625] Another commenter recommended that the Commission cover plans "defined in" ERISA.[626]

A collective group of three commenters argued that the definition of special entity should include only employee benefit plans that are "subject to" ERISA.[627] This group asserted that, "[s]ince Congress included a separate 'governmental plans' prong in the definition of special entity, the 'employee benefit plan' prong necessarily excludes governmental plans (both domestic and foreign) and should be read narrowly to include

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623 Proposing Release, 76 FR at 42422 n.182, supra note 3.

624 See Church Alliance (August 2011), supra note 5. See also Church Alliance (October 2011), supra note 5.

625 Id.

626 See CalPERS (August 2011), supra note 5.

627 See FIA/ISDA/SIFMA, supra note 5.

only employee benefit plans "subject to" ERISA."[628] However, one of these commenters later independently submitted a comment after the CFTC adopted business conduct rules, and expressed its support for an "opt in" approach.[629] This commenter asserted that the special entity definition should be limited to employee benefit plans that are "subject to" ERISA, although other employee benefit plans defined in ERISA, such as church plans, should be allowed to opt in to special entity status. According to this commenter, these modifications would harmonize the SEC and CFTC special entity definitions.

One commenter suggested treating plans subject to ERISA and government plans subject to ERISA similarly, so long as both are acting as end-users and are otherwise complying with their fiduciary obligations.[630] Another commenter suggested including governmental plans as special entities, arguing that "the taxpayers and government workers who stand behind government pensions are precisely the sort of constituents Congress sought to protect through the heightened protections of special entities."[631]

More broadly, one commenter recommended that the business conduct standards should only apply to certain governmental special entities, and that they should not apply to ERISA plans – since these plans already have similar or greater protections under ERISA.[632] The commenter argued that, by applying these standards to all special entities, the SEC "has extended its regulatory reach significantly beyond the scope of the statute,"

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628 Id.

629 See SIFMA (August 2015), supra note 5.

630 See CalSTRS, supra note 5.

631 See CFA, supra note 5.

632 See ABC, supra note 5.

resulting in "redundant" or "overlapping" regulations.[633] The commenter recommended that the proposed rules be modified to exclude ERISA plans with security-based swap advisors that are "already sufficiently regulated."[634]

iv. Master Trusts

The Commission additionally requested comment regarding whether to include a master trust that holds the assets of one or more funded plans of a single employer and its affiliates within the special entity definition. Three commenters supported the treatment of master trusts as special entities.[635]

One comment letter suggested that the term "special entity" should be modified to include master trusts holding the assets of one or more funded plans of a single employer.[636] Another comment letter urged the Commission to clarify that master trusts would be treated as special entities, noting that, by making this clarification, the SEC would harmonize the interpretation of its rules with that of the CFTC.[637]

One commenter urged the Commission to include church benefit boards that hold the assets of multiple church plans, church endowments, and other church-related funds on a commingled basis within the special entity definition, arguing that the functions of church benefit boards are similar to those of tax-exempt trusts, or master trusts established by several multiple-employer pension plans, and that such a definition would

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633 Id.

634 Id.

635 See FIA/ISDA/SIFMA, supra note 5; Church Alliance (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

636 See FIA/ISDA/SIFMA, supra note 5.

637 See SIFMA (August 2015), supra note 5.

reflect the close relationship – recognized in ERISA – between church benefit boards and their constituent church plans.[638]

v. Collective Investment Vehicles

The Commission requested comment regarding whether to interpret "special entity" to include a collective investment vehicle in which one or more special entities had invested. All eight commenters that commented on this question opposed the designation of collective investment vehicles as special entities, even where such collective investment vehicles have special entity investors.[639]

Commenters generally argued that requiring SBS Entities to investigate or "look through" their collective investment vehicle counterparties to determine whether they held special entity investments would create uncertainty in the market, increase compliance costs, disrupt the gains of special entity investors, and restrict special entities' access to security-based swaps – since collective investment vehicle managers may either limit or reject investments by special entities to avoid limitations on their security-based swap trading activities.[640]

One commenter asked the Commission to clarify that it would not "look through" collective investment vehicles to align its interpretation of the special entity definition with that of the CFTC. [641]

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638 See Church Alliance (August 2011), supra note 5.

639 See ABC, supra note 5; SIFMA (August 2011), supra note 5; ABA Committees, supra note 5; FIA/ISDA/SIFMA, supra note 5; BlackRock, supra note 5; MFA, supra note 5; NACUBO, supra note 5; SIFMA (August 2015), supra note 5.

640 Id.

641 See SIFMA (August 2015), supra note 5.

Two commenters argued to exclude collective investment vehicles because these vehicles are almost always passive investors, and that including them within the adopted rules would serve no regulatory purpose, since Congress' intent was to protect special entities as defined within the statute.[642]

Lastly, two commenters urged the Commission to exclude hedge funds, even where a special entity invests in that hedge fund.[643]

vi. Endowments

The Commission requested comment regarding how to apply the special entity definition to endowments, and whether certain organizations that qualify as endowments should be included in that definition. The five commenters addressing this issue suggested that the Commission limit the definition of endowments in the special entity context, with various caveats.[644]

Three commenters suggested limiting the definition of "endowments" to endowments that, themselves, enter into swaps.[645] Two of these commenters urged the Commission to clarify that the term "endowments" would not include non-profit organizations whose assets might include funds designated as an endowment,[646] while another asked that the Commission exclude organizations that use endowment assets to

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642 See ABA Committees, supra note 5; NACUBO, supra note 5.

643 See FIA/ISDA/SIFMA, supra note 5; BlackRock, supra note 5.

644 See FIA/ISDA/SIFMA, supra note 5; NABL, supra note 5; NACUBO, supra note 5; ABA Committees, supra note 5; SIFMA (August 2015), supra note 5.

645 See FIA/ISDA/SIFMA, supra note 5; NABL, supra note 5; NACUBO, supra note 5.

646 See FIA/ISDA/SIFMA, supra note 5; NABL, supra note 5.

pledge, maintain, enhance or support the organization's collateral obligations.[647] Another commenter similarly requested that the Commission interpret the definition of endowment to exclude charitable organizations that enter into security-based swaps for which their counterparties have recourse to the organizations' endowment.[648] The commenter noted that, by making this clarification, the SEC would bring its interpretation of the rules into harmony with that of the CFTC.[649]

The last commenter requested clarification that private foundations would not be included within the special entity definition.[650] The commenter argued that these foundations are, by statute, non-profit organizations that are not publicly supported, and that "no evidence" exists that Congress intended to treat private foundations as "endowments" under Dodd-Frank.[651]

Similarly, this same commenter suggested that "institutional investor organizations" (such as large non-profits and "sophisticated" endowments) with over $1 billion of net assets under management should be excluded from the special entity definition, since large "sophisticated" endowments employ professional money managers already subject to oversight and review.[652] The commenter argued that a special entity designation for these organizations could reduce the number of SBS Entities willing to

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647 See NACUBO, supra note 5.

648 See SIFMA (August 2015), supra note 5.

649 Id.

650 See ABA Committees, supra note 5.

651 Id.

652 See ABA Committees, supra note 5.

trade in security-based swaps, given the increased compliance costs associated with evaluating the qualifications of an independent representative.

vii. Foreign Plans, Foreign Entities

The Commission requested comment on whether to exclude from the definition of "special entity" any foreign entity. Six commenters responded to this issue.[653] All six commenters asserted that foreign entities should not be deemed special entities, although one commenter recommended that the U.S. reserve the right to extend application of its business conduct standards to foreign entities if international regulatory efforts fail.[654]

Four other commenters objected to the inclusion of foreign pension and employee benefit plans within the special entity definition on the grounds that the statutory language reflected a lack of Congressional intent to provide special protection for such plans under Dodd-Frank, and that extending the SEC's authority outside the United States would create the potential for conflict with other nations' regulatory regimes.[655]

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653 See ABC, supra note 5; SIFMA (August 2011), supra note 5; Johnson, supra note 5; BlackRock, supra note 5; CFA, supra note 5; PensionsEurope, supra note 7.

654 See Johnson, supra note 5. This same commenter argued that Congress limited the territorial scope of Title VII to activities within the United States, and that extraterritorial application of these laws should only apply when international activities of U.S. firms have a "direct and significant connection with or effect on U.S. commerce," or are designed to evade U.S. rules. Id. For further discussion, see Cross Border Application and Availability of Substituted Compliance, Section III.

655 See ABC, supra note 5; BlackRock, supra note 5; SIFMA (August 2011), supra note 5.

These commenters requested that the Commission revise the proposed definition of "special entity" to specifically exclude foreign entities.[656]

c. Response to Comments and Final Rule

After consideration of all comments, the Commission has determined to modify the scope of the special entity definition as described below.

i. Federal Agency

As noted above, the Commission did not receive any comments on the inclusion of federal agencies within the special entity definition. The Commission continues to believe it is appropriate to include federal agencies within the special entity definition, and is therefore adopting Rule 15Fh-2(e)(1) as proposed, renumbered as Rule 15Fh-2(d)(1).

ii. State and Municipal Special Entities

After further consideration and in light of the comment received, the Commission is modifying proposed Rule 15Fh-2(e)(2), adopted as Rule 15Fh-2(d)(2), to further define state and municipal entities to include "any instrumentality, department, or a corporation of or established by a State or political subdivision of a State."[657] As the Commission explained in another context, states may delegate powers to their political subdivisions,

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656 One commenter urged the Commission to only apply the business conduct standards to security-based swap transactions involving U.S. counterparties. See PensionsEurope, supra note 7, discussed in Section III below.

657 See SIFMA (August 2015), supra note 5; and SIFMA (November 2015), supra note 5 (asking the Commission to clarify that an instrumentality, department, or a corporation of, or established by, a State or political subdivision of a State is a special entity). This is consistent as well with the ECP definition for governmental entities, which includes "an instrumentality, agency, or department" of a State or political subdivision of a State. See Section 3(a)(65) of the Exchange Act, referring to Section 1a(18)(A)(vii)(III) of the CEA.

including the power to create corporate instrumentalities.[658] Similarly, the Commission believes a department or a corporation organized as a municipal corporate instrumentality of a state's political subdivision should be considered a municipal corporate instrumentality of a state. Corporate instrumentalities, departments, or corporations created by states or their political subdivisions are therefore taxpayer-backed institutions. Consequently, the Commission believes it is important to include "any instrumentality, department, or a corporation of or established by a State or political subdivision of a State" within the special entity definition to provide heightened protections for taxpayer-backed institutions that transact in security-based swaps.

In addition, the inclusion of this language will conform the special entity definition to that of a "municipal entity" in the Exchange Act, as well as to the CFTC's definition of State and municipal special entities, thereby providing all categories of municipal entities with heightened protections,[659] as well as addressing the commenter's concern regarding the need for a consistent definition across the security-based swaps and swaps markets.[660] This consistency should result in efficiencies for entities that transact in security-based swaps, particularly where such entities have already established a compliance infrastructure that satisfies the requirements of the existing CFTC business conduct standards.

iii. Employee Benefit Plans and Governmental Plans

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658 See Municipal Advisor Registration Release, 78 FR at 67483, supra note 5.

659 See Exchange Act Section 15B(e)(8), 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").

660 See SIFMA (August 2015), supra note 5; and SIFMA (November 2015), supra note 5.

Upon further consideration and in light of the comments received, the Commission is modifying proposed Rule 15Fh-2(e)(3), which stated "any employee benefit plan defined in Section 3 of [ERISA]" to state in adopted Rule 15Fh-2(d)(3) "any employee benefit plan subject to Title I of [ERISA]." Under this modification, Rule 15Fh(2)(d)(3) only includes employee benefit plans that are subject to regulation under Title I of ERISA. Furthermore, proposed Rule 15Fh-2(e)(4), renumbered as Rule 15Fh-2(d)(5), is being adopted as proposed, to include "any governmental plan, as defined in section 3(32) of [ERISA]."

In reaching this determination, we believe that Exchange Act Sections 15F(h)(2)(C)(iii) (employee benefit plans defined in Section 3 of ERISA) and 15F(h)(2)(C)(iv) (governmental plans defined in Section 3 of ERISA) should be read together "to avoid rendering superfluous" any statutory language of the Exchange Act.[661] As discussed above in Section II.H.1.b.3, Exchange Act Section 15F(h)(2)(C)(iii), read literally as any employee benefit plan "defined in" Section 3 of ERISA, would render Section 15F(h)(2)(C)(iv) superfluous, since governmental plans "defined in" ERISA are specifically designated as special entities under Section 15F(h)(2)(C)(iv). The Commission therefore agrees with the commenter that Congress' separate inclusion of governmental plans within the special entity definition supports a narrower reading of Section 15F(h)(2)(C)(iii), such that the definition only includes employee benefit plans "subject to" regulation under ERISA.[662]

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661 Astoria Fed. Sav. & Loan Assn. v. Solimino, 501 U.S. 104, 112 (1991).

662 See FIA/ISDA/SIFMA, supra note 5.

We recognize that this interpretation of "special entity" would exclude other types of employee benefit plans "defined in" Section 4(b) of ERISA, including church plans and workmen's compensation plans. Therefore, upon further consideration, and in response to commenters who support a broader interpretation of the term "special entity," including those commenters who assert that a church plan should be treated as a special entity, the Commission has determined to include an additional prong to the special entity definition.[663] Specifically, Rule 15Fh-2(d)(4), as adopted, defines a special entity to include "[a]ny employee benefit plan defined in Section 3 of [ERISA] and not otherwise defined as a special entity, unless such employee benefit plan elects not to be a special entity by notifying a security-based swap dealer or major security-based swap participant of its election prior to entering into a security-based swap with the particular security-based swap dealer or major security-based swap participant." The Commission believes that the inclusion of this additional provision appropriately resolves any tension between Exchange Act Sections 15F(h)(2)(C)(iii) and (iv), while granting broad coverage under the enhanced business conduct protections for special entities provided by the Dodd Frank Act.

Under Rule 15Fh-2(d)(4), as adopted, an employee benefit plan that is "defined in" Section 3 of ERISA but not "subject to" regulation under ERISA is included within the special entity definition, although it may elect to opt out of special entity status by notifying an SBS Entity counterparty of its election to opt out prior to entering into a security-based swap. Therefore, for example, under Rule 15Fh-2(d)(4), any church plan,

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663 See Church Alliance (August 2011), supra note 5; CalPERS (August 2011), supra note 5; Church Alliance (October 2011), supra note 5; SIFMA (August 2015), supra note 5.

as defined in Section 3(33) of ERISA, would be considered a special entity unless it elected to opt out of special entity status.[664] It is also consistent with Rule 15Fh-3(a)(3), which requires an SBS Entity to verify whether a counterparty is eligible to elect not to be a special entity, and if so, to notify the counterparty of its right to make such an election.[665] Further, by requiring employee benefit plans to notify SBS Entities of their decision to opt out, the provision will provide SBS Entities greater clarity regarding their counterparty's election to be treated as a special entity, as requested by a commenter.[666]

We note that the special entity definition the Commission is adopting today differs from the CFTC's special entity definition, which instead includes an opt-in provision for plans "defined in" ERISA.[667] While we agree with the CFTC's objective of "providing protections broadly,"[668] we have determined that inclusion of an opt-out provision will afford the maximum protections to the broadest categories of special entities, while still allowing them the flexibility to elect not to be special entities when they do not wish to avail themselves of those protections. In making this determination, we acknowledge the commenter's request that we conform our special entity definition to that of the CFTC..[669] However, we believe that the practical effect of an opt-out versus an opt-in regime should be minimal since, in either case, the SBS Entity will need to

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664 See Church Alliance (August 2011), supra note 5.

665 See Section II.G.1.b, supra.

666 See Church Alliance (August 2011), supra note 5.

667 See CFTC Adopting Release, 77 FR at 9774, supra note 21.

668 77 FR at 9776.

669 See SIFMA (August 2015), supra note 5.

advise the counterparty of its option to be treated as a special entity. The result should be greater clarity for SBS Entities regarding the regulatory status of their counterparties.

Lastly, we disagree with the commenter's assertions that the SEC "has extended its regulatory reach" beyond the statute by applying the business conduct rules to ERISA plans, and that the resulting regulations would overlap with the preexisting regulations established under ERISA.[670] As noted above, the plain language of Exchange Act Section 15F(h)(2)(C)(iii) includes ERISA plans within the special entity definition, and we continue to believe that such plans are deserving of the heightened protections of the business conduct rules specific to special entities. Moreover, wherever practical, we have adopted bifurcated rules that acknowledge the existing federal regulatory framework for ERISA plans, thereby minimizing the tension that may arise between that framework and the business conduct standards adopted today.[671]

iv. Master Trusts

The Commission agrees with commenters that master trusts should be treated as special entities, where a master trust holds the assets of more than one ERISA plan, sponsored by a single employer or by a group of employers under common control.[672] In

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670 See ABC, supra note 5.

671 See, e.g., Section II.H.2.c.ii, infra.

672 See FIA/ISDA/SIFMA, supra note 5; Church Alliance (August 2011), supra note 5; SIFMA (August 2015), supra note 5. See also Section 403(a) of ERISA (in general, "assets of an employee benefit plan shall be held in trust by one or more trustees") (29 U.S.C. 1103(a)); DOL Regulation 29 CFR 2520.103-1(e) (requiring the plan administrator of a Plan which participates in a master trust to file an annual report on IRS Form 5500 in accordance with the instructions for the form relating to master trusts); see also IRS Form 5500 Instructions, at 9 ("For reporting purposes, a 'master trust' is a trust . . . in which the assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.").

this regard, the Commission clarifies that, if a master trust holds the assets of an ERISA plan, the SBS Entity may satisfy the business conduct requirements being adopted today by treating the master trust as a special entity, rather than applying the business conduct rules to each underlying ERISA plan in a master trust. The Commission understands that a single employer or a group of employers under common control may sponsor multiple ERISA plans that are combined into a master trust to achieve economies of scale and other efficiencies. In such cases, the Commission does not believe that any individual ERISA plan within the master trust would receive any additional protection if the SBS Dealer or Major SBS Participant had to separately comply with the final rules with respect to each ERISA plan whose assets are held in the master trust.

The Commission similarly agrees with the commenter that, where a church benefit board holds the assets of multiple church plans as defined in Section 3(33) of ERISA, the function of the church benefit board is similar to that of a master trust.[673] Because church plans are recognized in ERISA, and a church benefit board holds only the assets of constituent church plans,[674] a church benefit board that holds the assets of church plans will be deemed a special entity under final Rule 15Fh-2(d)(4), although it will have the ability to opt out of special entity protections.

Lastly, this clarification addresses the commenter's request that the Commission interpret the special entity definition in harmony with the CFTC, as the CFTC also includes master trusts as special entities where a master trust holds the assets of more than one ERISA plan, sponsored by a single employer or by a group of employers under

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673 See Church Alliance (August 2011), supra note 5.

674 See generally 29 U.S.C. 1003(b).

common control.[675] Such uniformity will help establish regulatory consistency across the security-based swap and swap markets, thereby creating efficiencies for SBS entities that transact in security-based swaps and swaps.

v. Collective Investment Vehicles

The Commission requested comment on whether to interpret "special entity" to include collective investment vehicles in which one or more special entities had invested. After consideration of the comments, the Commission has determined not to interpret "special entity" in that way. The Commission agrees with commenters that uniformly urged the Commission not to treat a collective investment vehicle as a special entity, solely because the collective investment vehicle may have one or more special entity investors.[676]

Unlike master trusts, formed for the purpose of holding assets of ERISA plans, a collective investment vehicle may be formed for a variety of reasons and only incidentally accept investments from special entities. We share the concerns of commenters that requiring SBS Entities to investigate or "look through" their collective investment vehicle counterparties to determine whether they held special entity

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675 See SIFMA (August 2015), supra note 5. See also CFTC Adopting Release, 77 FR at 9776, supra note 21.

676 See ABC, supra note 5; SIFMA (August 2011), supra note 5; ABA Committees, supra note 5; FIA/ISDA/SIFMA, supra note 5; BlackRock, supra note 5; MFA, supra note 5; NACUBO, supra note 5; SIFMA (August 2015), supra note 5. See ABC, supra note 5; SIFMA (August 2011), supra note 5; ABA Committees, supra note 5; FIA/ISDA/SIFMA, supra note 5; BlackRock, supra note 5; MFA, supra note 5; NACUBO, supra note 5; SIFMA (August 2015), supra note 5. For clarification, and in response to commenters, the term "collective investment vehicle" in our discussion includes, but is not limited to, hedge funds that hold the assets of special entity investors. See FIA/ISDA/SIFMA, supra note 5; BlackRock, supra note 5.

investments could create uncertainty in the market, and could potentially increase compliance costs, disrupt the gains of special entity investors, and restrict special entities' access to security-based swaps – since collective investment vehicle managers may either limit or reject investments by special entities to avoid application of the special entity requirements.[677]

At the same time, we recognize the potential benefits of applying heightened protections to special entities that have invested in collective investment vehicles, either by applying those protections to the collective investment vehicle itself or requiring the SBS Entity to "look through" the collective investment vehicle. After further consideration, we have determined that it would neither be appropriate to treat the entire collective investment vehicle as a special entity, nor to require an SBS Dealer to "look through" the collective investment vehicle to determine whether any of its investors qualify as special entities. While the special entity has made the decision to invest in the collective investment vehicle, it is the collective investment vehicle that enters into the security-based swap – not the special entity. In light of the foregoing, we do not believe that collective investment vehicles should be included within the special entity definition.

Lastly, our decision not to include collective investment vehicles in the special entity definition will address the commenter's suggestion that we harmonize the Commission's special entity definition with that of the CFTC to increase regulatory consistency across the security-based swap and swap markets.[678]

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677 Id.

678 See SIFMA (August 2015), supra note 5.

vi. Endowments, Non-Profit Organizations, and Private Foundations

The Commission requested comment regarding application of the special entity definition to endowments. After taking into consideration the comments, the Commission has determined to interpret the term "endowment," as used in Section 15F(h)(2)(C)(v) of the Exchange Act, not to include entities or persons other than the endowment itself. The Commission therefore agrees with commenters that special entity status should be limited to endowments that are, themselves, counterparties to security-based swaps.[679] Accordingly, the Commission does not interpret the term "endowment" to include organizations that use endowment assets to pledge, maintain, enhance or support the organization's collateral obligations, or situations where a counterparty has recourse to the organization's endowment.[680]

For clarification, and in response to comment,[681] a private foundation will be subject to special entity protections where the private foundation qualifies as an endowment under applicable state laws, rules, or regulations, including the Uniform Prudent Management of Institutional Funds Act. Although we acknowledge the commenter's assertion that private foundations typically derive their financial support through private donations,[682] we do not agree that public funding is a prerequisite to special entity status, or that private funding should necessarily exclude a foundation from qualifying for special entity status.

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679 See FIA/ISDA/SIFMA, supra note 5; NABL, supra note 5; NACUBO, supra note 5.

680 See NACUBO, supra note 5; SIFMA (August 2015), supra note 5.

681 See ABA Committees, supra note 5.

682 Id.

As noted above in Section II.G.1.b, Rule 15Fh-3(a)(2) generally requires an SBS Entity to verify whether its counterparty is a special entity before entering into the security-based swap with that counterparty. Such verification should generally include a determination whether the counterparty may be deemed an endowment under applicable state law, as described above. However, as discussed in Section II.G.1.b, supra, counterparties may make representations about their status as special entities at the outset of a relationship with an SBS Entity, and can "bring down" that representation for each relevant action involving a security-based swap.

Also, as with collective investment vehicles, we believe that a more expansive interpretation of the special entity definition would require a burdensome "look through" process to determine whether endowment funds had, for instance, been invested or used as collateral in a particular security-based swap, and could ultimately restrict the ability of entities that are neither themselves endowments nor special entities (such as organizations described in section 501(c)(3) of the Internal Revenue Code of 1986 whose assets merely include funds designated as an endowment) to transact in security-based swaps.

By making the foregoing clarifications, the Commission more closely aligns its interpretation of the term "endowment" with that of the CFTC.[683] This consistency in the

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683 See CFTC Adopting Release, 77 FR at 9776, supra note 21 ("The Commission agrees with commenters that the Special Entity prong with respect to endowments is limited to the endowment itself. Therefore, the endowment prong of the Special Entity definition under Section 4s(h)(2)(C)(v) and § 23.401(c)(5) applies with respect to an endowment that is the counterparty to a swap with respect to its investment funds. The definition would not extend to charitable organizations generally. Additionally, where a charitable organization enters into a swap as a counterparty, the Special Entity definition would not apply where the

definition will address the commenter's concern regarding the need to promote regulatory clarity, and result in operational efficiencies for entities that have been operating under the CFTC's business conduct regime since 2012.[684]

Lastly, as discussed in more detail above in Section II.A.2.d., we decline the commenter's suggestion to permit endowments to opt out of special entity status.[685] As stated in the Proposing Release, Congress created heightened protections to mitigate the potential for abuse in SBS transactions with special entities, as the financial sophistication of special entities varies greatly.[686] As discussed above in Section II.A, the rules being adopted today are intended to provide certain protections for counterparties, including certain heightened protections for special entities. We think it is appropriate to apply the rules so that counterparties receive the benefits of those protections and do not think it is appropriate to permit parties to "opt out" of those provisions. Furthermore, we note that the CFTC's adopted rules do not contain such an opt-out provision, and that Swap Entities and their special entity counterparties have been operating under this regime since 2012. For all of the foregoing reasons, and to achieve regulatory consistency across the security-based swap and swap markets, we decline to adopt an opt-out provision for endowments in the final rules.

vii. Foreign Plans and Foreign Entities

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organization's endowment is contractually or otherwise legally obligations to make payments on the swap….").

684 See SIFMA (August 2015), supra note 5.

685 Id.

686 See Proposing Release, 76 FR at 42401, supra note 3.

The Commission requested comment on whether to exclude from the definition of "special entity" any foreign entity. After considering the comments, all of which asserted that foreign entities should not be deemed special entities, the Commission is declining to include foreign entities within the definition of "special entity." The Commission believes that, as stated in the Cross-Border Adopting Release, the term "special entity" applies to "legal persons organized under the laws of the United States."[687] This reading addresses the concerns raised by commenters regarding the need for clarification concerning the application of the rules as they relate to special entity-specific provisions.[688]

2. "Acts as an Advisor" to a Special Entity

a. Proposed Rule

As discussed below in Section II.H.3, Section 15F(h)(4)(B) of the Exchange Act imposes a duty on an SBS Dealer acting "as an advisor" to a special entity to act in the best interests of the special entity.[689] The Dodd-Frank Act does not define the term

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687 See Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities; Final Rule; Republication, 79 FR 47278, 47306 n.234 (Aug. 12, 2014) ("Consistent with the proposal, 'special entities,' as defined in Section 15F(h)(2)(C) of the Exchange Act, are U.S. persons because they are legal persons organized under the laws of the United States").

688 See ABC, supra note 5; SIFMA (August 2011), supra note 5; BlackRock, supra note 5. For a more detailed discussion on the cross-border application of U.S. business conduct standards, see Section III, infra.

689 Under proposed Rule 15Fh-4(b), an SBS Dealer that "acts as an advisor" to a special entity regarding a security-based swap must: (1) act in the best interests of the special entity; and (2) make reasonable efforts to obtain such information that the SBS 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. See Section II.H.3, infra.

"advisor," nor does it establish specific criteria for determining when an SBS Dealer is acting as an advisor within the meaning of Section 15F(h)(4).

The Commission proposed Rule 15Fh-2(a), which states that an SBS 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." We explained in the Proposing Release that, for these purposes, to "recommend" has the same meaning as that discussed in connection with Rule 15Fh-3(f).[690]

While the Dodd-Frank Act does not preclude an SBS Dealer from acting as both advisor and counterparty, the Commission recognized in the Proposing Release that it could be impracticable for an SBS Dealer acting as a counterparty to a special entity to meet the "best interests" standard imposed by Section 15F(h)(4) if it were deemed to be acting as an advisor to the special entity.[691] Proposed Rule 15Fh-2(a) would therefore provide a three-pronged safe harbor for an SBS Dealer to establish that it is not acting as an advisor. To qualify for the safe harbor, the SBS Dealer's special entity counterparty must first represent in writing that it will not rely on the SBS Dealer's recommendations, but that it will instead rely on advice from a "qualified independent representative."[692] Second, the SBS Dealer must have a "reasonable basis" to conclude that the special entity is being advised by a qualified independent representative.[693] Toward this end, the SBS Dealer could rely on the special entity's written representations unless the SBS Dealer has information that would cause a reasonable person to question the accuracy of the

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690 See Proposing Release, 76 FR at 42424, supra note 3.

691 Id.

692 Proposed Rule 15Fh-2(a)(1).

693 Proposed Rule 15Fh-2(a)(2).

representation.[694] Third, the SBS Dealer must disclose that it is not undertaking to act in the special entity's best interests, as would otherwise be required under Section 15F(h)(4).[695]

b. Comments on the Proposed Rule

The Commission received numerous comments in response to the definition of "acts as an advisor" to a special entity in proposed Rule 15Fh-2(a). One commenter asserted that the meaning of the phrase "acts as an advisor to a special entity" was critical to several regulatory rulemakings, and that this term should be applied as consistently as possible.[696] That commenter and another recommended that, in developing recommendations for the final rules, the Commission staff coordinate with the Commission staff working on rules regarding municipal advisors, as well as the MSRB and the CFTC.[697] The commenter urged the Commission to work with the CFTC and the MSRB to make the definition as consistent as possible across regulatory regimes.

However, the majority of comment letters addressing proposed Rule 15Fh-2(a) related to: (1) the use of the term "recommends" when defining the phrase "acts as an advisor to a special entity;" and (2) the safe harbor from acting as an advisor to a special entity set forth in proposed Rule 15Fh-2(a)(1) – (3). These comments are summarized below.

i. "Recommends" an SBS or Related Trading Strategy to a Special Entity

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694 See also discussion on SBS Entities acting as counterparties to special entities, Section II.H.5, infra.

695 Proposed Rule 15Fh-2(a)(3).

696 See NABL, supra note 5.

Eight comment letters addressed whether an SBS Dealer should be deemed to act as an advisor if it "recommends" a security-based swap or trading strategy to a special entity.[698]

One commenter argued that the definition of "acting as an advisor" was too narrow, and should be expanded to include not only making recommendations, but also providing "more general information and opinions."[699] That commenter and another recommended that the definition of "act as an advisor" should parallel that of an "investment adviser," such that the definition would encompass advising special entities as to the value of a security-based swap or as to the advisability of a security-based swap or trading strategies involving security-based swaps.[700] The second commenter asserted that this definition would more closely conform the definition of "act as an advisor" to the definition of "investment adviser" under the Advisers Act, as well as to the definition of "commodity trading advisor" under the CEA, while preserving the benefits of the Commission's proposed safe harbor.[701]

A third commenter generally supported our proposed approach, noting that "defining recommendations as advice is consistent . . . with congressional intent."[702] The

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698 See Better Markets (August 2011), supra note 5; CFA, supra note 5; Ropes & Gray, supra note 5; APPA, supra note 5; FIA/ISDA/SIFMA, supra note 5; NACUBO, supra note 5; SIFMA (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

699 See Better Markets (August 2011), supra note 5.

700 Id. Under the commenter's approach, the SBS Dealer need not receive compensation for the advice to be deemed acting as an advisor. See also FIA/ISDA/SIFMA, supra note 5.

701 See FIA/ISDA/SIFMA, supra note 5.

702 See CFA, supra note 5.

commenter, however, would narrow the definition of advice to "recommendations related to a security-based swap or a security-based swap trading strategy that are made to meet the objectives or needs of a specific counterparty after taking into account the counterparty's specific circumstances."[703] Another commenter suggested that the term "recommendation" exclude communications to groups of customers or to investment managers with multiple clients, unless the communication was tailored to a member of the group or to a specific client known to the SBS Dealer.[704] According to the commenter, the Commission should clarify that a recommendation must be tailored to the circumstances of a known special-entity counterparty before giving rise to advisor status, because, without this clarification, general communications to investment advisers (that potentially have special entity clients) might result in the SBS Dealer unknowingly "acting as an advisor."[705] In 2015, after the CFTC adopted its final business conduct rules, a commenter similarly proposed that the Commission narrow the scope of the definition of "act as an advisor to a special entity" to include only recommendations that are "tailored to the particular needs or characteristics of the special entity."[706]

Another commenter argued that a definition premised on an SBS Dealer's "recommend[ing]" a security-based swap or related trading strategy was "overly broad and unwise," and that acting as an advisor "requires a more formal, acknowledged

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703 Id.

704 See FIA/ISDA/SIFMA, supra note 5.

705 Id.

706 See SIFMA (August 2015), supra note 5. As the commenter stated, these modifications would harmonize the SEC and CFTC standards for determining when a Swap Dealer or SBS Dealer is acting as an advisor to a special entity. In addition, the commenter argued that this modification would align the definition with applicable guidance under the Advisers Act.

agency, as part of a relationship of trust and confidence."[707] This commenter expressed concern that a definition based on recommendations could chill communications, including informal "market chatter."[708] Two other commenters similarly urged the Commission to adopt a bright line, objective standard, where an explicit agreement by the parties would determine whether the SBS Dealer acts as advisor to the special entity.[709] Under this approach, unless the special entity and SBS Dealer agree that information provided by the SBS Dealer would form the primary basis for an investment decision, the SBS Dealer's communications would not be considered a "recommendation" under proposed Rule 15Fh-2(a).[710]

Several commenters requested that the Commission clarify whether certain communications constitute "acting as an advisor." One commenter was concerned that an SBS Dealer could provide a counterparty with data, analysis, and opinions that constituted recommendations in fact, but were not labeled or characterized as such.[711] A second commenter suggested the Commission clarify that the phrase "acting as an advisor" does not include providing general transaction, financial or market information to the special entity.[712] A third commenter recommended the final rule clarify that an SBS Dealer's "customary product explanations and marketing activities, provision of

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707 See Ropes & Gray, supra note 5.

708 Id.

709 See SIFMA (August 2011), supra note 5; APPA, supra note 5 (arguing that special entities would suffer the economic impact of the uncertainty resulting from a "facts and circumstances" test).

710 Id.

711 See Better Markets (August 2011), supra note 5.

712 See CFA, supra note 5.

general market information, quotes in response to requests, and information pursuant to requirements in the business conduct rules would not constitute 'acting as an advisor' to a special entity."[713]

ii. Safe Harbor

The Commission received a number of comment letters on the proposed rule's safe harbor provisions. Ten comment letters generally supported the safe harbor, subject to various suggestions or objections.[714] Three commenters objected to the safe harbor.[715]

Commenters supporting the adoption of safe harbor provisions that would protect an SBS Dealer from being deemed an advisor to a special entity, argued that market participants would benefit from greater certainty provided by the safe harbor, which would enable contracting parties to specify the nature of their relationship.[716]

A number of commenters, however, expressed concern about the possible interaction of the proposed safe harbor with ERISA. One commenter, for example, generally agreed with the proposed safe harbor but expressed concern that requiring an SBS Dealer to have a "reasonable basis" to believe a special entity was being advised by a qualified independent representative could allow the SBS Dealer's opinion of an ERISA plan representative to "trump" that of the ERISA plan

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713 See SIFMA (August 2011), supra note 5.

714 See ABC, supra note 5; GFOA, supra note 5; NABL, supra note 5; NACUBO, supra note 5; APPA, supra note 5; FIA/ISDA/SIFMA, supra note 5; Ropes & Gray, supra note 5; Black Rock, supra note 5; SIFMA (August 2015), supra note 5; SIFMA (November 2015), supra note 5.

715 See Better Markets (August 2011), supra note 5; CFA, supra note 5; AFSCME, supra note 5.

716 See NABL, supra note 5; APPA, supra note 5; FIA/ISDA/SIFMA, supra note 5; NACUBO, supra note 5.

fiduciary.[717] For these reasons, the commenter urged the Commission to prohibit an SBS Dealer that acts as a counterparty to an ERISA plan from vetoing the plan's choice of representative.[718]

Another commenter suggested the proposed safe harbor be revised to provide that either: (1) the special entity will rely on advice from a qualified independent representative, or (2) if the special entity or its representative is relying on the Qualified Professional Asset Manager ("QPAM") or In-House Asset Manager ("INHAM") Exemption, the decision to enter into the transaction will be made by a QPAM or INHAM.[719] One commenter expressed concern with the proposed safe harbor's requirement that the special entity represent it is not "relying" on recommendations from the SBS Dealer.[720] As the commenter explained, since reliance is one of the essential

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717 See ABC, supra note 5. The commenter expressed concern that such a veto power could render the Department of Labor's Prohibited Transaction Class Exemption 84-14 for Qualified Professional Asset Managers ("QPAMs") unavailable, and make ERISA plan representatives hesitant to vigilantly represent the plan's interests for fear of a future veto. The commenter also argued that, through this same provision, an SBS Dealer acting as an ERISA plan counterparty could learn confidential information regarding the plan or its representative.

718 Id.

719 See BlackRock, supra note 5. Section 406(a) of ERISA generally prohibits the fiduciary of a plan from causing the plan to engage in various transactions with a "party in interest" (as defined in Section 3(14) of ERISA), unless a statutory or administrative exemption applies to the transaction. Prohibited Transaction Exemption 84-14 (the "QPAM Exemption"), an administrative exemption, permits certain parties in interest to engage in transactions involving plan assets if, among other conditions, the assets are managed by a "qualified professional asset manager" (QPAM), which is independent of the parties in interest. Prohibited Transaction Exemption 96-23 (the "INHAM Exemption")provides similar conditional prohibited transaction relief for certain transactions involving plan assets that are managed by an in-house asset management affiliate of a plan sponsor.

720 See Ropes & Gray, supra note 5.

elements of a securities fraud action, an SBS Dealer could seek to rely on the special entity's representation that it did not "rely" on the SBS Dealer's recommendation in defense of a subsequent securities fraud action against the SBS Dealer.[721] Instead, the commenter suggested "as a purely technical matter" that the safe harbor instead require a special entity to acknowledge that the SBS Dealer is not acting as advisor to the special entity.[722]

In August 2015, another commenter suggested modifying the proposed rule to harmonize with the CFTC's approach by creating a second separate safe harbor for employee benefit plans subject to Title I of ERISA that "recognizes the unique fiduciary regime already applicable to such special entities."[723] In addition to recommending a safe harbor for ERISA plans, the commenter requested two changes to the non-ERISA safe harbor: (1) adding a requirement that an SBS Dealer may not express an opinion as to whether a special entity should enter into the recommended security-based swap or related trading strategy; and (2) eliminating the safe harbor condition that an SBS Dealer have a reasonable basis to believe that the special entity is advised by a qualified independent representative.[724] The commenter noted that the "reasonable basis" provision is absent from the parallel CFTC business conduct rule, and argued that the provision is unnecessary in light of the fact that the SBS Dealer will already receive a written representation that the special entity will rely on advice from the independent

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721 Id.

722 Id.

723 See SIFMA (August 2015), supra note 5.

724 See SIFMA (November 2015), supra note 5.

representative.[725] The commenter explained that its suggested modifications were generally intended to bring the Commission's safe harbor provisions into conformity with those of the CFTC.[726] The same commenter subsequently urged the Commission to either (i) permit SBS Entities to reasonably rely on written representations that satisfy the CFTC's safe harbor, or (ii) adopt a parallel safe harbor.[727]

Three commenters opposed the proposed safe harbor, arguing that it would erode the statutory protections for special entities. For instance, one commenter argued that the safe harbor would effectively allow SBS Dealers to give advice that might not be in the best interests of the special entity.[728] A second commenter opposed the safe harbor on the grounds that it would cause special entities to waive their right to "best interest" recommendations as a condition of transacting with SBS Dealers, and force them to rely solely on an independent representative that might be "financially beholden to the security-based swap industry."[729] The commenter also expressed concern that "in any transaction involving a customized swap, the special entity will by definition be relying on the swap dealer's assertion that the customization was designed with the particular needs of the special entity in mind," and if the SBS Dealer knows or has reason to know that the swap is not in the best interests of the special entity, the SBS Dealer "should be

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725 Id.

726 Id.

727 Id.

728 See Better Markets (August 2011), supra note 5.

729 See CFA, supra note 5.

precluded from doing the transaction regardless of what representations the special entity provides about who it may be relying on."[730]

Similarly, a third commenter characterized the safe harbor as permitting "an SBS Dealer to escape the critical responsibilities associated with 'acting as an advisor' by having Special Entities waive this right," and expressed concern that special entities would be forced to sign "boilerplate" waivers to enter into a security-based swap.[731]

c. Response to Comments and Final Rule

As stated above, proposed Rule15Fh-2(a) defined what it means for an SBS Dealer to act as an advisor to a special entity, and proposed Rule 15Fh-4 imposed certain requirements on SBS Dealers acting as advisors. Thus, the proposed rules would not impose these obligations on Major SBS Participants.[732] One commenter stated its view that it is appropriate to impose Rule 15Fh-4(b)'s heightened standards of conduct on professional market participants that are likely to be acting as advisors to special entities,[733] and another commenter stated that the "dealer-like obligations" of Rule 15Fh-4(b) should not be imposed on Major SBS Participants, transacting at arm's-length, as they will not likely advise special entities with respect to security-based swap

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730 Id.

731 See AFSCME, supra note 5.

732 Although Section 15F(h)(2)(A) of the Exchange Act generally requires all SBS Entities to comply with the requirements of Section 15F(h)(4), the specific requirements of Sections 15F(h)(4)(B) and (C), by their terms, apply only to SBS Dealers that act as advisors to special entities.

733 See CFA, supra note 5 (arguing that the determining factor in whether a rule should apply to a Major SBS Participant is whether it is engaged in conduct that would appropriately be regulated under the relevant standard).

transactions.[734] The Commission continues to believe that it is appropriate not to impose the heightened obligations when acting as an advisor to a special entity on Major SBS Participants, given the nature of their participation in the security-based swap markets.[735] However, if a Major SBS Participant is, in fact, recommending security-based swaps or trading strategies involving security-based swaps to a special entity, this could indicate that the Major SBS Participant is actually engaged in security-based swap dealing activity.[736] A Major SBS Participant that engages in such activity above the de minimis threshold in Exchange Act Rule 3a71-2 would need to register as an SBS Dealer and comply with the obligations imposed on SBS Dealers, including the obligations imposed by Rule 15Fh-4(b) when an SBS Dealer is acting as an advisor to a special entity.

Upon review and consideration of the comments, the Commission is adopting Rule 15Fh-2(a) as described below.

i. "Recommends" an SBS or Related Trading Strategy to a Special Entity

We are adopting, as proposed, Rule 15Fh-2(a), under which an SBS Dealer is defined to "act as an advisor to a special entity" when it recommends a security-based

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734 See MFA, supra note 5.

735 See Section II.C.3 (discussing bases for applying certain requirements to SBS Dealers but not to Major SBS Participants).

736 See Proposing Release, 76 FR at 42416 n.140, supra note 3. See also Definitions Adopting Release, 77 FR at 30618, supra note 108 ("Advising a counterparty as to how to use security-based swaps to meet the counterparty's hedging goals, or structuring security-based swaps on behalf of a counterparty, also would indicate security-based swap dealing activity.").

swap or a trading strategy that involves a security-based swap to a special entity.[737] For these purposes, to "recommend" has the same meaning as discussed in connection with Rule 15Fh-3(f).[738] The determination of whether an SBS Dealer has made a "recommendation" turns 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.[739]

The Commission is not expanding the definition of "recommendation" to encompass "more general information and opinions," as suggested by a commenter.[740] Such a broad definition could have the unintended consequence of chilling commercial communications, restricting customary commercial interactions, and generally reducing market information shared with special entities regarding security-based swaps.[741] As we discussed in Section II.G.4, the Commission continues to believe that the meaning of the term "recommendation" is well-established and familiar to intermediaries in the financial services industry, including broker-dealers that rely on institutional suitability determinations, and we believe that the same meaning should be ascribed to the term in this context.

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737 Although we are adopting Rule 15Fh-2(a), as proposed, we are adopting the safe harbor under proposed rule 15Fh-2(a)(1)-(3) with various modifications, as discussed in Section II.H.2.c.ii, infra.

738 See Section II.G.4, infra.

739 See Proposing Release, 76 FR at 42415, supra note 3. As discussed in Section II.G.4, supra, this is consistent with the FINRA approach as to what constitutes a recommendation.

740 See Better Markets (August 2011), supra note 5.

741 See, e.g., Ropes & Gray, supra, note 5.

As explained in Section II.G.4, the 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."[742] 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."[743] Thus, in response to commenters' requests for clarification, an SBS Dealer typically would not be making a recommendation – and would therefore not be "acting as an advisor" to a special entity with a duty to act in the "best interests" of a special entity – solely by reason of providing general financial or market information or transaction terms in response to a request for competitive bids.[744] Furthermore, provision of information pursuant to the requirements of the business conduct rules will not, in and of itself, result in an SBS Dealer being viewed as making a "recommendation," as suggested by one commenter.[745] Rather, as stated above, the determination of whether providing information about the valuation of a security-based swap, or concerning the advisability of a security-based swap or a trading strategy, involving a security-based swap constitutes a "recommendation" turns on the particular facts and circumstances.

To avoid unnecessarily narrowing the definition of "recommendation," we decline to limit the definition of "act as an advisor" to recommendations that are designed to

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742 Our approach here is consistent with that of the CFTC. See CFTC Adopting Release, 77 FR at 9783, n. 699, supra note 22.

743 Id. at n. 698.

744 See CFA, supra note 5; SIFMA (August 2011), supra note 5. See also Proposing Release, 76 FR at 42415, supra note 3.

745 See SIFMA (August 2011), supra note 5.

meet the needs of a specific counterparty after taking into account the counterparty's individual circumstances.[746] We also decline to exclude from the definition of "recommendation" communications to groups of customers or to investment managers with multiple clients.[747] We believe that such an exclusion could unnecessarily deprive groups or special entity investors of the intended protections of the rules when there are communications regarding a particular security-based swap or trading strategy to a targeted group of special entities that share common characteristics, e.g., school districts. As stated above, such communications should be evaluated based on whether, in light of all the facts and circumstances, the communications could "reasonably could be viewed as a 'call to action'" and "reasonably would influence an investor to trade a particular security or group of securities."[748] We also note that the number of recipients of a given communication does not necessarily change the characteristics of the communication.

Furthermore, we are not limiting the definition of "act as an advisor" to a special entity to situations in which parties affirmatively contract or otherwise establish "more formal, acknowledged agency relationships that are part of a relationship of trust and confidence"[749] We believe this could limit the scope of the obligations and corresponding protections for special entities when an SBS Dealer "acts as an advisor" in a manner that is not consistent with the intended objectives of the rule. In short, the rule

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746 See CFA, supra note 5.

747 See FIA/ISDA/SIFMA, supra note 5.

748 See Section II.G.4, supra.

749 See Ropes & Gray, supra note 5; SIFMA (August 2011), supra note 5; APPA, supra note 5.

could be stripped of its intended protections if those protections only applied when the regulated entity agreed to be regulated.[750]

For the same reason, SBS Dealers may not avoid making a "recommendation" as defined in this context through disclaimer, or simply by not characterizing or labeling a recommendation as such.[751] An interpretation that would permit an SBS Dealer to disclaim its "best interests" duty, irrespective of the SBS Dealer's conduct, could essentially relieve SBS Dealers of their obligations and deprive special entities of the corresponding protections intended by Rule 15Fh-4. Rather than require the affirmative agreement of the parties to establish an advisory relationship, we are providing a safe harbor, as described in Section II.H.2.c.ii, infra, by which the parties can agree that an SBS Dealer is not "acting as an advisor" to a special entity where certain conditions are met – specifically, where the special entity agrees to rely on the advice of an ERISA fiduciary or other qualified, independent representative with respect to a security-based swap transaction.

We reject the commenters' suggestion that we conform the definition of an SBS Dealer that "acts as an advisor" to a special entity to the definition of "investment adviser" under the Advisers Act, or to the definition of "commodity trading advisor" under the CEA.[752] We do not agree that either definition is necessarily tailored to the specific attributes of security-based swap transactions or the unique relationships between SBS Dealers and their special entity counterparties; therefore we believe that those

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750 The CFTC has taken the same approach in its treatment of swap dealers. See CFTC Adopting Release, 77 FR at 9785, supra note 22.

751 See Better Markets (August 2011), supra note 5.

752 See Better Markets (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5.

definitions would not necessarily provide special entities that trade in security-based swaps with the protections the business conduct rules are intended to provide.

The Commission continues to believe that the duties imposed on an SBS Dealer that "acts as an advisor" (as well as the definition of "act as an advisor" under Rule 15Fh-2(a)) are supplemental to any duties that may be imposed under other applicable law.[753] In particular, we acknowledge the commenter's suggestion that the Commission coordinate with the MSRB regarding the definition of "acts as an advisor."[754] As explained in Section I.E, supra, we have adopted rules that provide an exemption from "municipal advisor" status for persons providing advice with respect to municipal financial products or the issuance of municipal securities where certain conditions are met, such as where the municipal entity is represented by an independent registered municipal advisor.[755] More generally, as discussed in Section I.E, supra, the duties imposed on an SBS Dealer under the business conduct rules are specific to this context, and are in addition to any duties that may be imposed under other applicable law. Thus, an SBS Dealer must separately determine whether it is subject to regulation as a broker-dealer, an investment adviser, a municipal advisor or other regulated entity.

Lastly, the Commission considered and agrees with the comment that the definition of "acting as an advisor" to a special entity should be applied as consistently as possible across various rulemakings, and that the Commission should coordinate with the

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753 See Proposing Release, 76 FR at 42424, supra note 13.

754 See FIA/ISDA/SIFMA, supra note 5

755 See Municipal Advisor Registration Release, supra note 54.

CFTC with respect to this definition.[756] As noted in Section I.C, the staffs of the Commission and the CFTC extensively coordinated and consulted in connection with their respective rulemakings in an effort to establish a consistent rule regime across the swap and security-based swap markets. These efforts are reflected in the rules adopted today.

We note that the Commission's definition of "acts as an advisor" to a special entity under Rule 15Fh-2(a) differs slightly from the CFTC's parallel rule, under which a swap dealer is deemed to be an advisor when it "recommends a swap or trading strategy involving a swap that is tailored to the particular needs or characteristics of the Special Entity."[757] While we agree that the more individually tailored the communication to a specific counterparty or a targeted group of counterparties about a swap, group of swaps or trading strategy involving the use of a swap, the greater the likelihood that the communication may be viewed as a "recommendation," we do not agree that a security-based swap communication must be so tailored to constitute a recommendation for purposes of Rule 15Fh-2(a). In adopting this more expansive definition of "acts as an advisor" to a special entity, the Commission believes that it will better provide the intended protections of the statute to groups of special entity investors that may be treated similarly by SBS Dealers, such as school districts.

ii. Safe Harbor

After the Commission issued the Proposing Release, the CFTC adopted final rules that provide two safe harbors from the definition of "acts as an advisor to a special

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[756] See NABL, supra note 5; FIA/ISDA/SIFMA, supra note 5

[757] 17 CFR 23.440(a).

entity." The first provides a safe harbor for communications between a swap dealer and an ERISA plan that has an ERISA fiduciary, and the second provides a safe harbor for communications between a swap dealer and any special entity (including a special entity that is an ERISA plan). Qualifying for either safe harbor requires specified representations in writing by the swap dealer and special entity. In response to requests from commenters, and upon further consideration, we are adopting an approach that similarly recognizes the use of ERISA fiduciaries by ERISA plans, thereby avoiding the potential conflict or confusion that may result where the existing ERISA rules intersect with the business conduct rules adopted today.[758]

In adopting a separate safe harbor for ERISA plans, we recognize that Congress has already established a comprehensive federal regulatory framework for ERISA plans. Such recognition of the existing federal regulatory framework for ERISA plans maintains statutory protections for ERISA plans, while addressing the potential conflict, recognized by commenters, between the ERISA rules and the business conduct standards we are adopting today.[759] Lastly, in adopting a bifurcated approach that provides a safe harbor specifically for ERISA plans and another that is available with respect to all special entities, we are responding to the commenter's request that we more closely align the Commission's rules with those of the CFTC to promote regulatory consistency and

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758 See ABC, supra note 5; BlackRock, supra note 5; SIFMA (August 2015), supra note 5.

759 Id.

operational efficiency for entities that have been operating under the CFTC's business conduct regime since 2012.[760]

Under Rule 15Fh-2(a)(1), as adopted, an SBS Dealer may establish that it is not acting as an advisor to a special entity that is an ERISA plan if the special entity is represented by a qualified independent representative that meets the standard for an ERISA fiduciary. Specifically, the rule provides that an SBS Dealer will not be acting as an advisor to an ERISA special entity if: (i) the ERISA plan represents in writing that it has an ERISA fiduciary; (ii) the ERISA fiduciary represents in writing that it acknowledges that the SBS Dealer is not acting as an advisor; and (iii) the ERISA plan represents in writing that: (A) it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the special entity receives from the SBS Dealer involving a security-based swap transaction is evaluated by an ERISA fiduciary before the transaction is entered into; or (B) any recommendation the special entity receives from the SBS Dealer involving a security-based swap transaction will be evaluated by an ERISA fiduciary before that transaction is entered into.

Allowing the ERISA plan to either make written representations about its policies and procedures or represent in writing that the security-based swap transaction will be evaluated by an ERISA fiduciary provides the ERISA plan greater flexibility in structuring its relationship with the SBS Dealer. Moreover, these requirements, taken together, are designed to ensure that the ERISA fiduciary, not the SBS Dealer, is evaluating the security-based swap transaction on behalf of the ERISA plan. As an

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760 See SIFMA (August 2015), supra note 5. See also CFTC Adopting Release, 77 FR at 9784, n. 701, supra note 22.

ERISA fiduciary is already required by statute to, among other things, act with prudence and loyalty when evaluating a transaction for an ERISA plan,[761] the Commission believes it is appropriate to provide the safe harbor for when an SBS Dealer would not be deemed to be acting as an advisor to the ERISA plan for purposes of this rule.

Under Rule 15Fh-2(a)(2), as adopted, an SBS Dealer can establish it is not acting as an advisor to any special entity (including a special entity that is an ERISA plan) when the special entity is relying on advice from a qualified independent representative that satisfies specific criteria. An SBS Dealer will not be "acting as an advisor" to any special entity (including a special entity that is an ERISA plan) if: (i) the special entity represents in writing that it acknowledges that the SBS Dealer is not acting as an advisor, and that the special entity will rely on advice from a qualified independent representative; and (ii) the SBS Dealer discloses that it is not undertaking to act in the best interests of the special entity.[762]

In adopting the safe harbor, the Commission agrees with commenters that the provisions in Rule 15Fh-2(a)(1)-(2) will reduce uncertainty regarding the role of an SBS Dealer when transacting with a special entity.[763] Requiring special entities (or their

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761 ERISA fiduciaries are required to act with both loyalty (see Section 404(a)(1)(A)) and prudence (see Section 404(a)(1)(B)) when evaluating a transaction for an ERISA plan. In addition, ERISA fiduciaries are subject to statutory prohibitions against entering into certain categories of transactions between a plan and a "party in interest" (see Section 406(a)), and prohibitions against self-dealing and other conflicts of interest (see Section 406(b)). See supra note 38.

762 However, as noted above in Section II.G.4.c.ii, an SBS Dealer that makes a recommendation to a special entity will still need to have a reasonable basis to believe that a recommended security-based swap or trading strategy involving a security-based swap is suitable for the special entity.

763 See NABL, supra note 5; APPA, supra note 5; FIA/ISDA/SIFMA, supra note 5; NACUBO, supra note 5.

fiduciaries) to affirm in writing that they acknowledge the SBS Dealer is not acting as an advisor, and that they will instead obtain advice from a qualified independent representative, will help ensure that the parties are aware of their respective rights and obligations regarding a security-based swap transaction. While our rules would permit an SBS Dealer to rely on the special entity's (or its fiduciary's) written representations, the SBS Dealer's reliance must still be reasonable, as required under Rule 15Fh-1(b). Specifically, the SBS Dealer may not rely on a representation if the SBS Dealer has information that would cause a reasonable person to question the accuracy of the representation.[764] The requirement that a special entity or its fiduciary represents in writing that it acknowledges the SBS Dealer is not acting as an advisor differs from the proposed safe harbor, which would have required the special entity to represent that it would not rely on the SBS Dealer's recommendations. The Commission is making this change in response to a commenter's concern.[765] The Commission does not intend to affect the rights of parties in private actions.

The safe harbor under 15Fh-2(a)(2), as adopted, also differs from the proposed rule, which would have required that an SBS Dealer must have a reasonable basis to believe that the special entity is advised by a qualified independent representative. Rather, under adopted Rule 15Fh-2(a)(2)(i), the safe harbor requires written representations from the special entity that it will rely on advice from a qualified

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764 Rule 15Fh-1(b).

765 See Ropes & Gray, supra note 5.

independent representative.[766] The Commission agrees with the commenter that requiring special entities to make representations to SBS Dealers in writing that they are relying on advice from a qualified independent representatives addresses the proposed rule's underlying policy concern – i.e., that the special entity is represented by a qualified independent representative.[767] Moreover, we believe that requiring special entities to effectively confirm that they have qualified independent representatives addresses the commenter's concern that the proposed rule would allow SBS Dealers to evaluate the qualifications of a special entity's independent representative and vest SBS Dealers with the authority to "trump" the special entity's choice of representative.[768] An SBS Dealer could rely on the special entity's written representations unless the SBS Dealer has information that would cause a reasonable person to question the accuracy of the representation, including the representation that the special entity is relying on advice from a qualified independent representative.

While we acknowledge commenters' concerns that the safe harbor might erode the statutory protections for special entities,[769] we also have considered the inherent tensions that arise where SBS Dealers have concurrent, potentially conflicting roles as advisor and counterparty to special entities. On the one hand, the SBS Dealer as advisor is subject to a duty to act in the "best interests" of the special entity. On the other hand, a

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766 In addition, the safe harbor as adopted continues to require that the SBS Dealer disclose to the special entity that it is not undertaking to act in the best interest of the special entity. See Rule 15Fh-2(a)(2)(ii).

767 See SIFMA (November 2015), supra note 5.

768 See ABC, supra note 5. See also Section II.H.5, infra.

769 See Better Markets (August 2011), supra note 5; CFA, supra note 5; AFSCME, supra note 5.

broad application of the "best interests" standard could have the unintended consequences of chilling commercial communications, restricting customary commercial interactions, reducing market information shared with special entities, as well as reducing the ability of special entities to engage in security-based swaps. In adopting the safe harbor, we acknowledge the tension between the SBS Dealer's potentially conflicting roles as advisor and counterparty by recognizing that the special entity may be separately advised by a fiduciary or other qualified independent representative, who will act in the special entity's best interests.

We disagree with commenters that adoption of the safe harbor could cause special entities to waive their right to "best interests" standards or sign "boilerplate agreements" as a condition of transacting with SBS Entities.[770] Rather, the safe harbor reflects an approach that is conditioned upon the involvement of an ERISA fiduciary or other qualified independent representative that is otherwise required to act in the best interests of the special entity.

Although the safe harbor the Commission is adopting today largely aligns with that of the CFTC, it differs from that of the CFTC in four respects: (1) Rules 15Fh-2(a)(1)(ii) and 15Fh-2(a)(2)(i)(A) require the special entity or its fiduciary to represent in writing that it acknowledges the SBS Dealer is not acting as an advisor, whereas the CFTC requires the special entity or its fiduciary to represent it will not rely on the SBS Dealer's recommendations;[771] (2) Rules 15Fh-2(a)(1)(iii)(A) and (B) apply to any recommendation the special entity receives from the security-based swap dealer

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770 See CFA, supra note 5; AFSCME, supra note 5.

771 See 17 CFR 23.440(b)(1)(ii), (b)(2)(ii)(A).

"involving" a security-based swap transaction, while the parallel CFTC rules apply to recommendations "materially affecting" a security-based swap transaction;[772] (3) Rule 15Fh-2(a)(1)(iii) requires a security-based swap transaction to be evaluated by a fiduciary before the transaction "is entered into," whereas the CFTC's safe harbor requires a swap transaction to be evaluated by fiduciary before the transaction "occurs";[773] and (4) the safe harbor in Rule 15Fh-2(a) does not prohibit an SBS Dealer acting as an advisor from expressing an opinion as to whether a special entity should enter into a recommended security-based swap or trading strategy.[774] The Commission believes it is appropriate to differ from the CFTC in these three discrete areas for the following reasons.

First, as discussed above, the Commission believes that replacing the requirement that the special entity or its fiduciary represent it will not "rely" on the SBS Dealer's recommendations with the requirement that the special entity or its fiduciary represent in writing that it acknowledges that the SBS Dealer is not "acting as an advisor" will afford special entities the same statutory protections. As noted above, the Commission is making this change in response to a commenter's concern.[775] The Commission does not intend to affect the rights of parties in private actions.

Second, the Commission has determined to replace the phrase "materially affecting" with the word "involving" in relation to the recommendations that a special entity receives from an SBS Dealer. We believe that further clarification is needed in the

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772 See 17 CFR 23.440(b)(1)(iii)(A)-(B).

773 See 17 CFR 23.440(b)(1)(iii).

774 Cf. 17 CFR 23.440(b)(2)(i).

775 See Ropes & Gray, supra note 5.

context of Rule 15Fh-2(a)(1) to make clear that all recommendations made by the SBS Dealer are covered by this provision.

Third, the Commission has determined to use the phrase "is entered into," as it is consistently used throughout the business conduct rules being adopted today.[776] However, because we also believe that the CFTC's usage of the word "occurs" was intended to have the same meaning as the phrase "is entered into," we expect the practical effect of CFTC Regulation 23.440(b)(1)(iii) to be substantially the same as Rule 15Fh-2(a)(1)(iii).[777]

Fourth, the Commission declines to adopt the provision in CFTC Regulation 23.440(b)(2)(i), under which Swap Dealers seeking to avail themselves of the safe harbor would be precluded from "expressing an opinion" as to whether the special entity should enter into a recommended security-based swap or trading strategy. Under the rules adopted today, the determination of whether an SBS Dealer has provided advice to a special entity turns on whether a communication is considered a "recommendation," not whether the SBS Dealer has "expressed an opinion." Unlike the word "recommendation," the phrase "express an opinion" is not defined or described in the federal securities laws in this context, and therefore may have other meanings that could cause confusion. Further, we also believe the concern that underlies the CFTC's

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776 See, e.g., Rule 15Fh-1 ("Sections 240.15h-1 through 240.15Fh-6, and 240.15Fk-1 apply, as relevant in connection with entering into security-based swaps…"); Rule 15Fh-3(a)(1), (2) ("…before entering into a security-based swap…"); Rule 15Fh-3(b) ("At a reasonably sufficient time prior to entering into a security-based swap…"); Rule 15Fh-6(b)(1) ("It shall be unlawful for a security-based swap dealer to offer to enter into, or enter into, a security-based swap…") (emphasis added).

777 See generally CFTC Adopting Release, 77 FR at 9784, supra note 22.

provision (i.e., that the special entity obtain advice regarding a security-based swap from an ERISA fiduciary or other qualified independent representative) is sufficiently addressed by the requirement in Rules 15Fh-2(a)(1)-(2) that the special entity or its fiduciary represent that it acknowledges that the SBS Dealer is not acting as an advisor. It is therefore the Commission's view that prohibiting SBS Dealers from "expressing an opinion" would neither increase regulatory clarity regarding whether an SBS Dealer's conduct falls within the safe harbor, nor provide a corresponding increase in protection for special entities.

3. Definition of "Best Interests"

Exchange Act 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.[778] The term "best interests" is not defined in the Dodd-Frank Act, and the Commission did not propose to define "best interests." In the Proposing Release, we noted that the "best interests" duty for an SBS Dealer acting as an advisor to a special entity "goes beyond and encompasses the general suitability requirement of proposed Rule 15Fh-3(f)." We sought comment on whether we should define the term "best interests," and if so, whether such definition should use

[778] Section 15F(h)(5) of the Exchange Act also requires an SBS Entity that is a counterparty to a special entity to have a "reasonable basis" to believe the special entity has an independent representative that undertakes to act in the best interests of the special entity.

formulations based on the standards applied to investment advisers,[779] municipal advisors,[780] ERISA fiduciaries,[781] or some other formulation.

a. Proposed Rules

Proposed Rule 15Fh-4(b)(1) would generally require an SBS Dealer that acts as an advisor regarding a security-based swap to a special entity to act in the "best interests" of the special entity.

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779 We have stated that 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 (Jul. 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).

780 See, e.g., Exchange Act Section 15B(b)(2)(L), 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). In April 2015, the MSRB filed proposed Rule G-42 with the Commission for approval, which rule would establish core standards of conduct for municipal advisors when engaging in municipal advisory activities, other than municipal advisory solicitation activities. The rule was published in the Federal Register on May 8, 2015. See Exchange Act Release No. 74860 (May 4, 2015), 80 FR 26752. See also Exchange Act Release Nos. 75628 (Aug. 6, 2015), 75737 (Aug. 19, 2015), and 76420 (Nov. 10, 2015). The rule was approved, with amendments, on December 23, 2015. See Exchange Act Release No. 76753 (Dec. 23, 2015).

781 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").

Proposed Rule 15Fh-4(b)(2) would require the SBS Dealer to make "reasonable efforts" to obtain the information 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, and that such 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.

b. Comments on the Proposed Rules

The Commission received six comment letters on the imposition of a "best interests" standard.[782] One commenter argued that the Commission should define what it means to act in the "best interests," and proposed that the definition must "be at least as strong as the concept of 'best interest' [that] has evolved under the fiduciary principles

[782] See Better Markets (August 2011), supra note 5; CFA, supra note 5; Johnson, supra note 5; ABC, supra note 5; BlackRock, supra note 5; SIFMA (August 2015), supra note 5.

applicable to investment [advisers]."[783] The commenter additionally requested that the Commission acknowledge "that the best interest standard intended by Congress is a fiduciary concept that goes well beyond suitability."[784]

Similarly, a second commenter supporting a best interests standard stated it did not believe it was "necessary, or even appropriate," to strictly define best interests.[785] The commenter asked the Commission to provide guidance on how to apply the standard in particular circumstances. This commenter asserted that Congress did not intend to apply the ERISA fiduciary standard, and argued that the intended model for the "heightened standard" was the Advisers Act fiduciary duty.[786] The commenter stated that Congress did not seek to eliminate all conflicts of interest but to ensure that such conflicts of interest would be appropriately managed and fully disclosed.[787] The commenter urged that in providing guidance in this area, it is important for the Commission to clarify that not all suitable recommendations would satisfy a best interest standard and that the best interest standard would impose a "heightened duty beyond mere suitability" and would require SBS Dealers to "recommend from among the various suitable options the approach they believe to be best for the special entity."[788] In addition, the commenter stated that the guidance should "clarify that the best interest standard is consistent with

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783 See Better Markets (August 2011), supra note 5 (noting that Congress expressly described the standard as "best interest" in Exchange Act Sections 15F(h)(2)(A) and (B), 15F(h)(4) and 15F(h)(5)).

784 Id.

785 See CFA, supra note 5.

786 Id.

787 Id.

788 Id.

various different methods of compensation and with proprietary trades, but that it requires the full disclosure of any conflicts of interest." In the context of an SBS Dealer acting as an advisor and serving as a counterparty, the commenter suggested that the Commission clarify that it would not be inconsistent with the SBS Dealer's duty to act in the best interests of the special entity if the SBS Dealer, as principal, earned a reasonable profit or fee from transacting with the special entity.[789]

A third commenter asserted that Congress rejected the imposition of a fiduciary duty on SBS Dealers as incompatible with their role as market makers and asked the Commission to "respect Congressional intent" to protect the ability of end users and pension plans to transact in security-based swaps in a cost-effective manner by rejecting such a duty.[790]

Two additional commenters argued that an SBS Dealer that "acts as an advisor to a special entity" and complies with the "best interest" requirements might become an ERISA fiduciary under the DOL's proposed redefinition of the term "fiduciary."[791] Accordingly, one of these commenters requested that the Commission clarify that compliance with the business conduct standards would not transform an SBS Dealer into a fiduciary under ERISA or under the final DOL regulation.[792]

One of these commenters also opposed the best interest requirement, and recommended that it be omitted from the final rules.[793] The commenter expressed its

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789 Id.

790 See Johnson, supra note 5.

791 See ABC, supra note 5; BlackRock, supra note 5.

792 See ABC, supra note 5.

793 See BlackRock, supra note 5.

concern that "[r]equiring that an SBS Dealer act in the best interests of a counterparty who is a special entity would confuse the roles of the parties and have an adverse impact on the flow of information regarding investment and trading strategies."[794] Additionally, if the requirement is retained, the commenter recommended that the term "best interests" be defined as complying with proposed Rule 15Fh-3(g) (fair and balanced communications),[795] and NASD Rule 2010(d), which would require that communications be based on principles of fair dealing and good faith, be fair and balanced, and provide a sound basis for evaluating the transaction.[796]

After the CFTC adopted its rules in 2012, one commenter asserted that "to promote legal certainty and the ability of SBS dealers to continue to trade with special entities, the SEC should provide guidance clarifying the nature of an SBS Dealer's 'best interests' duty."[797] Specifically, the commenter asserted that, to harmonize with CFTC guidance, the Commission should clarify that the best interest duty is not a fiduciary duty, but is rather a duty for the SBS Dealer to: (1) comply with the requirement to make a reasonable effort to obtain necessary information; (2) act in good faith and make full and fair disclosure of all material facts and conflicts of interest with respect to the recommended security-based swap or related trading strategy; and (3) employ reasonable care that any recommendation made to the special entity be designed to further the special entity's stated objectives.[798] The commenter also suggested that, consistent with

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794 Id.

795 See Section II.G.5, supra.

796 Id.

797 See SIFMA (August 2015), supra note 5.

798 Id.

the CFTC's guidance, a recommendation need not represent the best of all possible alternatives to meet the best interest standard. Additionally, the commenter stated that the determination whether a recommendation is in a special entity's best interest should be based on the information known to the SBS Dealer at the time a recommendation was made.[799] Furthermore, according to the commenter, the best interest duty should not impede an SBS Dealer from negotiating the terms of a transaction in its own interests, or from making a reasonable profit in a transaction; nor should it impose an ongoing obligation on the SBS Dealer to act in the best interest of the special entity.[800] This commenter also suggested deleting the requirement under Rule 15Fh-4(b)(i) that the SBS Dealer "make reasonable efforts to obtain information regarding 'the authority of the special entity to enter into a security based swap.'"[801] Toward this end, the commenter argued that the CFTC eliminated this requirement as it was "duplicative" of the know your customer requirement under the CFTC's business conduct rules. As the commenter stated: "Since proposed Rule 15Fh3(e)(3) would require an SBS dealer to obtain this information, we believe the same considerations support eliminating that requirement here."[802] Moreover, the commenter proposed a bifurcated treatment of ERISA and non-ERISA special entities under Rule 15Fh-5(a) to recognize the "unique fiduciary regime" already applicable to ERISA special entities, as well as to "reduce costs for special

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799 Id.

800 Id.

801 Id.

802 Id.

entities since most of them have already conformed their relationships with their representatives to satisfy the CFTC's qualification criteria."[803]

c. Response to Comments and Final Rules

Upon consideration of commenters' views, the Commission is adopting Rules 15Fh-4(b)(1) and (2), regarding the "best interests" obligation for an SBS Dealer that acts as an advisor to a special entity regarding a security-based swap, with certain modifications.

Under Rule 15Fh-4(b)(1), as adopted, an SBS Dealer that acts as an advisor to a special entity will have a "duty to make a reasonable determination that any security-based swap or trading strategy involving a security based swap recommended by the security based swap dealer is in the best interests of the special entity." We believe that this language, suggested by a commenter,[804] appropriately interprets the statutory requirements imposed on an SBS Dealer that is acting as an advisor to a special entity.[805] While the Commission is not specifically defining the term "best interests," it is providing further guidance below regarding how an SBS Dealer that acts as an advisor to a special entity can comply with the duty to make a reasonable determination that a security-based swap or security-based swap trading strategy is in the "best interests" of the special entity.

Under Rule 15Fh-4(b)(2), as adopted, the advisor will be obligated to "make reasonable efforts to obtain such information that the security-based swap dealer

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803 Id.

804 See SIFMA (August 2015), supra note 5.

805 Proposed Rule 15Fh-4(b)(1) generally required an SBS Dealer to "act in the best interests of the special entity."

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." Whether a recommended security-based swap or trading strategy is in the best interests of the special entity is based on information known to the advisor (after it has employed its reasonable efforts under Rule 15Fh-4(b)(2)) at the time the recommendation is made.

Various commenters questioned whether the "best interest" duty was tantamount to, or would give rise to, a "fiduciary duty."[806] The Commission has considered commenters' views and the legislative history in regard to whether Section 15Fh-4 imposes a fiduciary duty.[807] As noted above, Rule 15Fh-4(b)(1), as adopted, requires that an SBS Dealer "make a reasonable determination that any security-based swap or trading strategy involving a security based swap recommended by the security based swap dealer is in the best interests of the special entity." In response to comments, and for clarification, the determination whether a recommended security-based swap or trading

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806 See, e.g., Better Markets (August 2011), supra note 5; CFA, supra note 5; Johnson, supra note 5; ABC, supra note 5; BlackRock, supra note 5.

807 In the Senate bill, the business conduct standards provision provided that "a security-based swap dealer that provides advice regarding, or offers to enter into, or enters into a security-based swap with [a Special Entity] shall have a fiduciary duty to the [Special Entity], as appropriate." Restoring American Financial Stability Act of 2010, H.R. 4173, Section 764 (May 20, 2010) (Public Print version as passed in the Senate of the United States May 27 (legislative day, May 26, 2010) (proposed amendments to Section 15F(h)(2)(A) and (B) of the Exchange Act), available at https://www.congress.gov/bill/111th-congress/house-bill/4173/text/pp). Instead, Congress adopted the following best interests standard: "Duty. -- Any security-based swap dealer that acts as an advisor to a Special Entity shall have a duty to act in the best interests of the Special Entity." H.R. Rep. No. 111-517, 111th Cong., 2d Sess., p. 423 (June 29, 2010) (Dodd-Frank Act Conference Report). See also Section 15F(h)(4)(B) of the Exchange Act.

strategy is in the "best interests" of the special entity will turn on the facts and circumstances of the particular recommendation and particular special entity. In response to a commenter, and as stated in the Proposing Release, we continue to believe that the "best interests" obligation for an SBS Dealer acting as an advisor to a special entity goes beyond and encompasses the general suitability requirements of Rule 15Fh-3(f).[808] The Commission generally believes that it would be difficult for an SBS Dealer acting as an advisor to a special entity to fulfill its obligations under Rule 15Fh-4(b)(1), as adopted, unless the SBS Dealer, at a minimum: (1) complies with the requirement of Rule 15Fh-4(b)(2) that it make a reasonable effort to obtain necessary information to make a reasonable determination that a security-based swap or related trading strategy is in the best interests of the special entity;[809] (2) acts in good faith and makes full and fair disclosure of all material risks and characteristics of and any material incentives or

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808 See Better Markets (August 2011), supra note 5; CFA, supra note 5. See also Proposing Release, 76 FR at 42417, supra note 3. This is the case even if the SBS Dealer is not acting as counterparty to the special entity for which it is acting as an advisor.

809 Also, as stated above, to comply with its customer-specific suitability obligations under Rule 15Fh-3(f)(1)(ii), an SBS Dealer must have a reasonable basis to believe 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 must have or obtain relevant information regarding the special entity, including its investment profile, trading objectives, and its ability to absorb potential losses associated with the recommended security-based swap or trading strategy involving a security-based swap. Furthermore, where an SBS Dealer's reasonable efforts to obtain necessary information result in limited or incomplete information, the SBS Dealer must assess whether it is able to make a reasonable determination that a particular recommendation is in the best interests of the special entity.

conflicts of interest with respect to the recommended security-based swap;[810] and (3) employs reasonable care that any recommendation made to a special entity is suitable taking into account the information collected by the SBS Dealer pursuant to Rules 15Fh-3(f)(1)(ii) and 15Fh-4(b)(2), including the special entity's objectives.[811] In taking reasonable care that any recommendation made to a special entity is suitable, an SBS Dealer acting as an advisor to a special entity should consider, among other things, the fair pricing and appropriateness of the security-based swap or trading strategy, and must act without regard to its own financial or other interests in the security-based swap transaction or trading strategy.[812] As discussed below, this does not prevent an SBS Dealer from negotiating commercially reasonable terms or earning a profit.

In response to commenters' requests for clarification, we do not believe that, to act in the best interests of a special entity, an SBS Dealer acting as an advisor would be

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810 The Commission believes that to "act in good faith" in this context generally involves taking steps to manage material conflicts of interest in addition to disclosing them.

811 See note 809, supra and Rule 15Fh-4(b)(2). An SBS Dealer generally should consider evaluating "best interests" in accordance with policies and procedures that are reasonably designed to prevent violations of the requirement that a recommended swap is in the best interests of the special entity. See Rule 15Fh-3(h)(2)(iii) (requiring SBS Entities to have supervisory policies and procedures that are reasonably designed to prevent violations of applicable federal securities laws and the rules and regulations thereunder). Furthermore, the Commission has separately proposed that SBS Dealers be required to make and keep current a record that demonstrates their compliance with Rule 15Fh-4, among others, as applicable. See Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers; Proposed Rules, Exchange Act Release No. 34-71958, 79 FR 25194 at 25208 (May 2, 2014).

812 Exercising reasonable care would also require, among other things, undertaking reasonable diligence to understand the potential risks and rewards associated with the recommended security-based swap or trading strategy. See Rule 15Fh-3(f)(1)(i).

required to recommend the "best" of all possible alternatives that might exist.[813] The determination whether a recommended security-based swap is in the "best interests" of the special entity must be based on information known to the SBS Dealer, acting as an advisor, (after it has employed its reasonable efforts under Rule 15Fh-4(b)(2)) at the time the recommendation is made. We believe that a broader requirement could introduce legal uncertainty into the determination of what an SBS Dealer must do to fulfill its obligation under the rule, given the broad range of objectives for which a security-based swap might be used, and how such objectives may vary for different transactions. The Commission believes, however, that generally an SBS Dealer should consider, based on the information about existing alternatives known to the SBS Dealer, any reasonably available alternatives in fulfilling its best interests obligations.

For further clarification in response to comments, we believe that the "best interests" duty would not necessarily preclude an SBS Dealer from acting as a counterparty.[814] However, an SBS Dealer acting in both capacities would be required to comply with the full range of requirements under Rules 15Fh-4 and 15Fh-5, applicable to SBS Dealers acting as advisors and as counterparties to special entities. In addition to the substantive requirements, Rule 15Fh-5(c) would require that the SBS Dealer disclose to the special entity in writing the capacities in which is it acting, and the material differences between its capacities as advisor and counterparty to the special entity.

We also do not believe that the "best interests" duty would prevent an SBS Dealer from negotiating commercially reasonable security-based swap terms in its own

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813 See CFA, supra note 5; SIFMA (August 2015), supra note 5.

814 See CFA, supra note 5.

interest,[815] or that it would preclude an SBS Dealer from making a reasonable profit or fee from a transaction with a special entity.[816] We do not believe that the profit motive inherent in any security-based swap transaction necessarily precludes an SBS Dealer, acting as an advisor, from fulfilling its "best interests" duty to a special entity, although it raises the potential for material conflicts that would need to be disclosed – particularly when the SBS Dealer is acting as both an advisor and a counterparty to the special entity. A prohibition on receipt of reasonable profits or fees would likely reduce SBS Dealers' willingness to act as advisors to and transact with special entities at the same time, and therefore could limit special entities' access to security-based swap transactions that might be necessary to their particular objectives.

As additional guidance in response to comments,[817] the "best interests" duty would not require the SBS Dealer acting as an advisor to undertake an ongoing obligation to act in the "best interests" of the special entity, unless such obligation is established through contract or other arrangement or understanding (e.g., a course of dealing). As noted above, Rule 15Fh-4(b), as adopted, requires an SBS Dealer to make a reasonable determination, after making reasonable efforts to obtain the necessary information, that a recommended security-based swap or related trading strategy is in the best interests of the

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815 See SIFMA (August 2015), supra note 5. For example, the SBS Dealer may negotiate appropriate provisions relating to collateral and termination rights to manage its risks related to the security-based swap.

816 See CFA, supra note 5. Furthermore, as noted throughout this release, the duties imposed on an SBS Dealer under these business conduct rules are specific to this context, and are in addition to any duties that may be imposed under other applicable law. Thus, an SBS Dealer must separately determine whether it is subject to regulation as a broker-dealer, an investment adviser, a municipal advisor or other regulated entity.

817 See SIFMA (August 2015), supra note 5.

special entity. Thus, the "best interests" duty applies only to recommendations by the SBS Dealer. For example, if an SBS Dealer makes a recommendation in connection with a material amendment to a security-based swap or a recommendation to terminate a security-based swap early, the "best interests" duty would apply. However, we note that an SBS Dealer would have an ongoing "best interests" duty if it were to assume the additional responsibility of monitoring a special entity's security-based swap transaction on an ongoing basis.

Commenters have suggested that we apply principles applicable to investment advisers under the Advisers Act in the "best interests" standard of Rule 15Fh-4(b).[818] As noted above in Section II.H.2.c.i., we believe that the protections included in the business conduct rules address the relationships between SBS Dealers and their special entity counterparties for which they act as advisors, so long as their activities are limited to those that would not, under the facts and circumstances, implicate other applicable law. However, as discussed in Section I.E, supra, the duties imposed on an SBS Dealer under the business conduct rules are specific to this context, and are in addition to any duties that may be imposed under other applicable law. Thus, an SBS Dealer must separately determine whether it is subject to regulation as a broker-dealer, an investment adviser, a municipal advisor or other regulated entity. We also decline to adopt a commenter's suggestion that we either omit the term "best interests" from the final rules, or state that "best interests" means complying with the fair and balanced communications requirements of Rule 15Fh-3(g) and FINRA Rule 2010 (Standards of Commercial Honor

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[818] See Better Markets (August 2011), supra note 5; CFA, supra note 5.

and Principles of Trade).[819] We do not believe that either approach would be consistent with the statute, which uses the terms "fair and balanced communications," "fair dealing," and "good faith" in separate provisions, indicating that they impose duties separate and apart from "best interests."[820]

The Commission also has modified the information that an SBS Dealer must "make reasonable efforts to obtain" and consider in making its reasonable determination that a security-based swap or security-based swap strategy is in the "best interests of the special entity." Specifically, Rule 15Fh-4(b)(2) now includes the special entity's hedging, investment, financing, or other stated objectives as information that shall be considered by the SBS Dealer in making this determination. The addition of "hedging" and "other" objectives in Rule 15Fh-4(b)(2)(iii) addresses a commenter's suggestion that these terms be included,[821] and recognizes that there may be a broader set of objectives for a special entity to enter into a security-based swap. The added language expressly recognizes special entities' use of security-based swaps to mitigate risk, as well as other possible uses for security-based swaps that might be necessary for a special entity to achieve these objectives. We believe that requiring an SBS Dealer to make reasonable

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819 See BlackRock, supra note 5. We interpret BlackRock's comment as referring to FINRA Rule 2010, (or its predecessors, NYSE Rule 2010 or NASD Rule 2110) which states: "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."

820 Compare Exchange Act Section 15F(h)(3)(C) (requiring business conduct requirements to "establish a duty for security-based swap dealer or major security-based swap participant to communicate in a fair and balanced manner based on principles of fair dealing and good faith") with Exchange Act Section 15F(h)(4)(B) ("Any security-based swap dealer that acts as an advisor to a special entity shall have a duty to act in the best interests of the special entity").

821 See SIFMA (August 2015), supra note 5.

efforts to obtain information about a wider array of possible investment objectives of special entities will allow SBS Dealers to more accurately determine a special entity's objectives in entering into a security-based swaps, which is one of the factors it must consider when making a best interest determination (as discussed above). Furthermore, as requested by a commenter, this change conforms the obligation under our rules with that under the rules of the CFTC.[822] Such conformity promotes regulatory consistency across the swap and security-based swap markets, particularly among entities that transact in both markets and have already established infrastructure to comply with existing CFTC regulations.

Furthermore, we reject the commenter's request to delete the requirement under proposed Rule 15Fh-4(b)(2)(i) that an SBS Dealer make reasonable efforts to obtain "information regarding the authority of the special entity to enter into a security-based swap."[823] In so doing, we disagree with the commenter's assertion that the requirement under Rule 15Fh-4(b)(2)(i) is "duplicative" of the "know your counterparty" requirement of Rule 15Fh-3(e)(3), which, according to the commenter, already imposes an obligation on SBS Dealers to obtain information about the authority of the special entity to enter into a security-based swap. To the contrary, the know your customer requirements of Rule 15Fh-3(e)(3) require an SBS Dealer to learn "information regarding the authority of

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822 Id. CFTC Regulation §23.440(c)(2)(iii) states that: "Any 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 swap or trading strategy involving a swap recommended by the swap dealer is in the best interests of the Special Entity, including… information relating to…the hedging, investment, financing, or other objectives of the Special Entity." See CFTC Adopting Release, 77 FR at 9825, supra note 22.

823 See SIFMA (August 2015), supra, note 5.

any person acting for such counterparty." A determination regarding the authority of any person acting for a counterparty (under Rule 15Fh-3(e)(3)) is different from a determination regarding the authority of the counterparty itself to enter into a security-based swap itself (under Rule 15Fh-4(b)(2)(i)). The SBS Dealer's duty to act in the best interests of a special entity would encompass the requirement to ensure that a special entity has the requisite authority to enter into an SBS transaction. Moreover, the "know your counterparty" requirements of Rule 15Fh-3(e)(3) only apply to known counterparties.[824] Also, the "know your counterparty" requirements apply only to counterparties, whereas the requirements imposed on SBS Dealers that "act as an advisor" to special entities are not limited to special entities that are counterparties. Accordingly, we continue to believe that requiring SBS Dealers to obtain information regarding the authority of a special entity to enter into a security-based swap is not duplicative, but is necessary to achieving the overarching purpose of the rule: determining whether a recommended security-based swap or related trading strategy is in the best interests of the special entity.

Lastly, as noted above, commenters requested that we clarify that an SBS Dealer that "acts as an advisor to a special entity" and complies with the "best interests" requirements of these business conduct standards will not necessarily become an ERISA fiduciary under the DOL's proposed (now final) redefinition of the term "fiduciary."[825] As discussed in Section I.D, supra, DOL staff has provided the Commission with a statement that:

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824 See Section II.G.3, supra.

825 See ABC, supra note 5; BlackRock, supra note 5; CFA, supra note 5.

> It is the Department's view that the draft final business conduct standards do not require security-based swap dealers or major security-based swap participants to engage in activities that would make them fiduciaries under the Department's current five-part test defining fiduciary investment advice. 29 CFR § 2510.3-21(c). The standards neither conflict with the Department's existing regulations, nor compel security-based swap dealers or major security-based swap participants to engage in fiduciary conduct. Moreover, the Department's recently published final rule amending ERISA's fiduciary investment advice regulation was carefully harmonized with the SEC's business conduct standards so that there are no unintended consequences for security-based swap dealers and major security-based swap participants who comply with the business conduct standards. As explained in the preamble to the Department's final rule, the disclosures required under the SEC's business conduct rules do not, in the Department's view, compel counterparties to ERISA-covered employee benefit plans to make investment advice recommendations within the meaning of the Department's final rule or otherwise compel them to act as ERISA fiduciaries in swap and security-based swap transactions conducted pursuant to section 4s(h) of the Commodity Exchange Act and section 15F of the Securities Exchange Act of 1934.[826]

4. Antifraud Provisions

a. Proposed Rule 15Fh-4(a)

Proposed Rule 15Fh-4(a) would track the language of Section 15F(h)(4)(A) of the Exchange Act, and prohibit an SBS Entity from: (1) employing any device, scheme, or artifice to defraud any special entity or prospective customer who is a special entity; (2) engaging in any transaction, practice, or course of business that operates as a fraud or deceit on any special entity or prospective customer who is a special entity; or (3) engaging in any act, practice, or course of business that is fraudulent, deceptive, or manipulative. The first two provisions are specific to an SBS Entity's interactions with special entities, while the third applies more generally.

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826 See Letter from Phyllis C. Borzi, Assistant Secretary, Employee Benefits Security Administration, U.S. Department of Labor to The Hon. Mary Jo White et al., SEC (Apr. 12, 2016).

b. Comments on the Proposed Rule

The Commission received two comment letters on this issue.[827] The first commenter argued that the antifraud provisions of proposed Rule 15Fh-4(a) would be duplicative in light of the general antifraud and anti-manipulation provisions of the existing federal securities laws and proposed Rule 9j-1.[828]

The second commenter argued that, because the antifraud prohibitions of proposed Rule 15Fh-4(a)(3) were modeled on language in the Advisers Act applicable to conduct by investment advisers, and SBS Entities do not typically act as advisers to their counterparties, the SEC should include an affirmative defense against alleged violations of the antifraud prohibitions in its final rules.[829] Specifically, the commenter suggested that the Commission establish an affirmative defense for an SBS Entity that: (1) did not act intentionally or recklessly in connection with such alleged violation; and (2) complied in good faith with written policies and procedures reasonably designed to meet the particular requirement that is the basis for the alleged violation.[830] The commenter noted that the CFTC included such a provision in its parallel business conduct rules, and urged the Commission to rely on the same considerations that led the CFTC to adopt its affirmative defense.[831]

c. Response to Comments and Final Rule

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827 See Barnard, supra note 5; SIFMA (August 2015), supra note 5.

828 See Barnard, supra note 5. See also Prohibition Against Fraud, Manipulation, and Deception in Connection With Security-Based Swaps, Exchange Act Release No. 34-63236, 75 FR 68560 (Nov. 8, 2011).

829 See SIFMA (August 2015), supra note 5.

830 Id.

831 Id.

After considering the comments, the Commission is adopting Rule 15Fh-4(a) as proposed. However, we are re-titling Rule 15Fh-4 "Antifraud provisions and special requirements for security-based swap dealers acting as advisors to special entities. We also are re-titling Rule 15Fh-4(a) "Antifraud provisions" and Rule 15Fh-4(b) "Special requirements for security-based swap dealers acting as advisors to special entities."

Rule 15Fh-4(a) codifies the statutory requirements of Exchange Act Section 15F(h)(4)(A).[832] Inclusion of the rule in the business conduct standards will provide SBS Entities and their counterparties with easy reference to the antifraud provisions that Congress expressly provided under Section 15F(h)(4) of the Exchange Act. These requirements, which by their terms are applicable to all SBS Entities, apply in addition to those prohibitions imposed by Section 9(j) of the Exchange Act – along with any rules the Commission may adopt thereunder, and any other applicable provisions of the federal securities laws and related rules and regulations. The Commission is not adopting the commenter's recommendation that the final rules incorporate an affirmative "policies and procedures defense." We recognize that the CFTC adopted an express, affirmative

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832 This language mirrors the language in Sections 206(2) and 206(4) of the Advisers Act, which does not require scienter to prove liability. See SEC v. Steadman, 967 F.2d 636, 647 (D.C. Cir. 1992). The court in Steadman analogized Section 206(4) of the Advisers Act to Section 17(a)(3) of the Securities Act, which the Supreme Court had held did not require a finding of scienter. See id., citing Aaron v. SEC, 446 U.S. 680 (1980). The Steadman court concluded that: "[S]ection 206(4) uses the more neutral 'act, practice, or course or business' language. This is similar to [Securities Act] section 17(a)(3)'s 'transaction, practice, or course of business,' which 'quite plainly focuses upon the effect of particular conduct . . . rather than upon the culpability of the person responsible.' Accordingly, scienter is not required under section 206(4), and the SEC did not have to prove it in order to establish the appellants' liability . . . ." SEC v. Steadman, 967 F.2d at 647 (internal citations omitted). The Steadman court observed that, similarly, a violation of Section 206(2) of the Adviser Act could rest on a finding of simple negligence. Id. at 642 note 5.

defense in its parallel antifraud rules, in part in response to concerns that the statute may impose non-scienter liability for fraud in private rights of action.[833] The Exchange Act, however, does not contain a parallel provision.[834] Moreover, the Commission has considered the concerns raised by commenters and determined not to provide a similar safe harbor from liability for fraud on behalf of SBS Entities. As discussed throughout the release in the context of specific rules, the rules being adopted today are intended to provide certain protections for counterparties, including certain heightened protections for special entities. We think it is appropriate to apply the rules so that counterparties receive the benefits of those protections, and therefore we do not think it would be appropriate to provide the safe harbor requested by the commenter from liability for fraud. While we are not adopting a safe harbor from liability for fraud, as discussed below in connection with the relevant rules, the Commission has adopted rules that permit reasonable reliance on representations (e.g., Rule 15Fh-1(b)) and, where appropriate, allow SBS Entities to take into account the sophistication of the counterparty (e.g., Rule 15Fh-3(f) (regarding recommendations of security-based swaps or trading strategies)).

5. SBS Entities Acting as Counterparties to Special Entities

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833 See CFTC Adopting Release, 77 FR at 9752, supra note 21 ("Even if the Commission were to limit the rule to require proof of scienter and apply the rule only when a swap dealer is acting as an advisor to a Special Entity, that would not restrict a court from taking a plain meaning approach to the language in Section 4s(h)(4) in a private action under Section 22 of the CEA").

834 See also Proposing Release, 76 FR 42401, fn. 44, supra note 3 ("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").

a. Scope of Qualified Independent Representative Requirement

i. Proposed Rules

Under Exchange Act Section 15F(h)(5)(A), an 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 the SBS Entity to have a "reasonable basis" to believe the special entity has an "independent representative" that meets certain qualifications. 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 that "offers to enter into" or enters into a security-based swap with a special entity to have a "reasonable basis" to believe that the special entity has a "qualified independent representative."

ii. Comments on the Proposed Rule

Application to SBS Dealers and Major SBS Participants

Under proposed Rule 15Fh-5(a), an SBS Dealer or a Major SBS Participant that offers to enter into or enters into an SBS with a special entity must have a reasonable basis to believe that the special entity has a qualified independent representative. Although Exchange Act Section 15F(h)(2)(B) only imposes an express obligation on SBS Dealers to comply with the requirements of Section 15F(h)(5), we proposed to apply the qualified independent representative requirement to Major SBS Participants as well as SBS Dealers because the specific requirements under Section 15F(h)(5)(A) apply by their

terms to both a "security-based swap dealer and major security-based swap participant that offers to or enters into a security-based swap with a special entity."[835]

The sole commenter on this issue supported the proposed Rule, and agreed that it should apply to both SBS Dealers and Major SBS Participants.[836]

Application to Any Special Entity

In proposed Rule 15Fh-5(a), we proposed to apply the qualified independent representative requirements to transactions with all special entities. In the Proposing Release, we explained that while Exchange Act Section 15F(h)(5)(A) provides broadly that an SBS Entity that offers to or enters into a security-based swap with a special entity must comply with the requirements of that section, Section 15F(h)(5)(A)(i) on its face would apply these requirements only to dealings only with "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." A reliance on Section 15Fh(5)(A)(i) read in isolation would lead to an anomalous result in which special entity obligations could apply with respect to entities such as multinational and supranational government entities, which are ECPs "within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of the Commodity Exchange Act," but that do not fall within the definition of special entity in Section 15F(h)(2)(C). Conversely, Section 15Fh(5)(A)(i) read in isolation could lead to special entity obligations not being applied with respect to

835 See 15 U.S.C. 78o-10(h)(5)(A).

836 See NAIPFA, supra note 5.

dealings with state agencies, which are special entities as defined in Section 15Fh(2)(C) but are not ECPs as defined in Section 1a(18)(A)(vii)(I) and (II) of the CEA.[837]

To resolve the ambiguity in the statutory language, we proposed to apply the qualified independent requirement under Section 15F(h)(5) to security-based swap transactions or offers to enter into security-based swap transactions between an SBS Entity and any counterparty that is a "special entity" as defined in Section 15F(h)(1)(C). This approach would address the statutory ambiguity by including dealings with 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).[838] The Proposing Release noted that this reading would be consistent with the categories of special entities mentioned in the legislative history.[839] 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.[840]

The Commission received one comment letter that addressed the question of whether proposed Rule 15Fh-5(a) should apply to security-based swap transactions with

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837 See Proposing Release, 76 FR at 42426, supra note 3.

838 Id. See also proposed Rule 15Fh-5(a).

839 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).

840 See Section 15F(h)(1)(C)(iii) of the Exchange Act.

any special entity.[841] According to the commenter, proposed Rule 15Fh-5(a) was overly broad in scope and ignored the limiting language of Section 15F(h)(5)(A). This commenter suggested interpreting the requirement as applying to only those referenced governmental entities that are special entities."[842]

Application to "Offers"

As stated above, proposed Rule 15Fh-5(a) would apply to an SBS Dealer or Major SBS Participant that "offers to enter into" or enters into a security-based swap with a special entity. The Commission requested comment regarding whether the phrase "offers to enter into" a security-based swap was sufficiently clear, and if not, how the requirement should be clarified.[843] Three commenters responded to this request.[844]

One commenter suggested that the "offer" stage of a security-based swap transaction would often be too early for the counterparty to ensure that the independent representative requirement was satisfied.[845] Instead, the commenter argued that the independent representative requirement should be satisfied if the counterparty had an

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841 See Ropes & Gray, supra note 5.

842 Id. The commenter suggested two other possible alternatives for resolving the statutory ambiguity: "(i) interpreting the de facto independent representative requirements as applying to both those referenced governmental entities that are special entities and those that are not, (ii) interpreting the independent representative requirement to be generally inapplicable (as clearly most special entities were not intended to be covered in the reference)" but expressed a preference for including governmental entities that are special entities "absent clarification from Congress."

843 See Proposing Release, 76 FR at 42426, supra note 3.

844 See APPA, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

845 See APPA, supra note 5.

independent representative at the time the transaction was executed.[846] A second commenter recommended that the Commission exclude preliminary negotiations from the definition of "offer," and that the communication of an interest in trading a security-based swap should only be viewed as an "offer" when, based on the relevant facts or circumstances, the communication was "actionable" or "firm."[847] A third commenter asked that the Commission, like the CFTC, clarify the term "offer" to mean an "offer to enter into an SBS that, if accepted, would result in a binding contract under applicable law."[848]

"Reasonable Basis"

The Commission additionally sought comment regarding the degree of inquiry required for an SBS Entity to form a "reasonable basis" to believe the special entity was represented by a qualified independent representative. Three commenters expressed concern with the additional duties of inquiry and diligence imposed on SBS Entities under proposed Rule 15Fh-5(a).[849] One of these commenters argued that the CFTC's proposed requirement that a Swap Dealer perform substantial diligence to confirm a swap advisor's qualifications could pose a serious conflict of interest, give the Swap Dealer too much power, and ultimately interfere with, prove more costly for, and be problematic to state or local governments.[850] Another commenter similarly argued that an inherent conflict of interest existed in granting one party to a transaction the authority to

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846 Id.

847 See FIA/ISDA/SIFMA, supra note 5.

848 See SIFMA (August 2015), supra note 5.

849 See MFA, supra note 5; GFOA, supra note 5; CalPERS, supra note 5.

850 See GFOA, supra note 5.

effectively determine who has the requisite qualifications to represent the other party.[851] The second commenter would impose additional due diligence obligations on SBS Entities before they could rely on special entities' representations regarding the qualifications of representatives, even where the SBS Entity does not have information that would cause a reasonable person to question the accuracy of the representations.[852] The commenter conceded that requiring such additional diligence might limit the willingness or ability of SBS Entities to provide special entities with access to security-based swaps. However, it argued that, in the absence of such diligence, special entities' access to security-based swaps should be limited to the extent suitability is in question.[853]

Other commenters expressed a range of views in response to our request for comment on whether an SBS Entity should be able to rely on representations to form the necessary "reasonable basis" for believing that a special entity counterparty is represented by a qualified independent representative. One commenter argued that no particular level of specificity should be required in the representations, and that the SBS Dealer should not be required to conduct further diligence before relying on the special

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851 See CalPERS, supra note 5. This commenter therefore recommended an approach that would permit a special entity to choose between either relying on the Commission's proposed framework, or relying on an alternative approach under which it would be permitted to enter into off-exchange security-based swap transactions with an SBS Entity if the special entity had a representative, whether internal or a third party, that had been certified as able to evaluate security-based swap transactions. The commenter contemplated that the certification process would involve passage of a proficiency examination to be developed by the Commission or FINRA "or another recognized testing organization." A certified independent representative would be required to complete periodic continuing education. Id.

852 See NAIPFA, supra note 5.

853 Id.

entity's representations, as "any such diligence would interfere with the relationship between the special entity and its independent advisor and could result in the SBS Dealer second-guessing the special entity's choice of representative."[854] Another commenter argued that an SBS Dealer should be required to rely on the representations of a special entity concerning the qualifications of its independent representative, absent actual knowledge of facts that clearly contradict material aspects of the representative's purported qualifications.[855]

One commenter suggested adopting a presumption that the special entity's selection of independent representative was acceptable if the special entity represents to the SBS Entity that the representative satisfies the criteria in Exchange Act Section 15F(h)(5)(A)(i).[856]

Two other commenters supported the actual knowledge standard because they believe the reasonable person standard in practice could require an SBS Entity to perform

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854 See BlackRock, supra note 5.

855 See SIFMA (August 2011), supra note 5. The commenter asserted that requiring an SBS Dealer to undertake an independent due diligence investigation into representative's qualifications would impose upon the SBS Dealer a duty to second-guess the special entity's own assessment of its representative and provide the SBS Dealer with the ability to trump a special entity's choice of asset manager. According to the commenter, this could result in a reduced number of security-based swap counterparties for special entities, as SBS Dealers would likely limit transactions with special entities to avoid the potential liability, cost, delay, and uncertainty arising from this added responsibility.

856 See ABA Committees, supra note 5. That presumption would be voidable only if one or more senior representatives of the SBS Entity with expertise in security-based swap transactions possessed actual knowledge that a representation regarding the independent representative's qualifications was false. In that situation, the Special Entity's senior representative must present his or her determination promptly in writing to the special entity's Chief Investment Officer and Chair of the Board, or equivalent person.

substantial due diligence to rely on representations.[857] One commenter noted that this additional due diligence could reduce the number of SBS Entities willing to contract with special entities, and could increase the cost of security-based swaps for those persons.[858] The other expressed concern that additional due diligence, in the context of the qualifications of a special entity's independent representative, would be intrusive, time consuming and unnecessary, and would "come very close to having the SBS Dealer 'approve' the special entity's representative."[859] A third commenter expressed similar concerns, noting that absent actual knowledge that a representation is incorrect, SBS Dealers should not be able to second-guess a special entity's selection of a representative.[860]

Another commenter supported permitting an SBS Dealer to rely on a special entity's representation that its independent representative met the statutory and regulatory requirements, unless the SBS Dealer had reason to believe that the special entity's representations with respect to its independent representative were inaccurate.[861]

After the adoption of the CFTC's final rules, one commenter urged the Commission to adopt the CFTC's reasonable person approach, under which an SBS

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857 See APPA, supra note 5; BlackRock, supra note 5.

858 See APPA, supra note 5.

859 See BlackRock, supra note 5.

860 See ABC, supra note 5. According to the commenter, without such a bright-line rule, SBS Dealers might face litigation initiated by ERISA plans for approving a representative who is subsequently determined to lack needed expertise, or by the representatives whom they have chosen to disqualify. This potential liability would ultimately discourage SBS Dealers from transacting with ERISA plans altogether.

861 See CCMR, supra note 5.

Entity would be deemed to have a reasonable basis to believe the special entity has a qualified independent representative when it relies on written representations that the special entity's representative meets the criteria for a qualified independent representative.[862] Alternatively, in the ERISA context, the commenter suggested that an SBS Entity be deemed to have a reasonable basis to believe a special entity subject to ERISA has a representative that satisfies the requirements for a qualified independent representative when it relies on written representations that the representative is a fiduciary as defined in Section 3 of ERISA.[863] The commenter's suggested modifications were intended to harmonize the SEC's standard with that adopted by the CFTC.[864]

Another commenter requested that the Commission clarify that any representations made by a special entity or its representative to satisfy the rules do not give any party any additional rights, such as rescission or monetary compensation (e.g., if the representations turn out to be incorrect).[865]

iii. Response to Comments and Final Rule

After consideration of the comments, we are adopting Rule 15Fh-5(a), subject to the modifications described below.

Application to SBS Dealers and Major SBS Participants

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862 Id.

863 Id.

864 Id.

865 See FIA/ISDA/SIFMA, supra note 5.

As a preliminary matter, we continue to believe and agree with the commenter that Rule 15Fh-5(a) should apply to both SBS Dealers and Major SBS Participants.[866] As discussed in Section II.C. above, in making this determination, the Commission recognizes that the statutory language of the business conduct standards generally does not distinguish between SBS Dealers and Major SBS Participants. Where the statute does make that distinction, the Commission also makes that distinction in the corresponding rule.[867] Here, we believe Congress intended to impose the independent representative requirement equally with respect to SBS Dealers and Major SBS Participants, since the specific requirements under Section 15F(h)(5)(A) of the Exchange Act apply by their terms to both "security-based swap dealer[s] and major security-based swap participant[s] that offer[] to or enter[] into a security-based swap with a special entity."[868] We also believe that the protections of Rule 15Fh-5 should inure equally to those special entities that transact with SBS Dealers as well as those that transact with Major SBS Participants.

Application to Any Special Entity

Moreover, the Commission continues to believe that the qualified independent representative requirements in Rule 15Fh-5 should apply whenever an SBS Entity acts as a counterparty to any special entity. We acknowledge the commenter's suggestion that the Commission "give appropriate effect to the limiting language in Exchange Act

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866 See NAIPFA, supra note 5.

867 For example, the requirements under Exchange Act Section 15F(h)(4)(B) apply only to an SBS Dealer that acts as an advisor to a special entity, a distinction that is reflected in Rule 15Fh-4(b).

868 See 15 U.S.C. 78o-10(h)(5)(A).

Section 15F(h)(5)(A)" regarding the types of special entities to which the independent representative requirement applies.[869] However, given the ambiguity between the language of Sections 15F(h)(2)(C) and 15F(h)(5)(A)(i), we believe that our interpretation is appropriate and promotes a more consistent reading of both provisions of the statute, providing protections to all special entities.[870]

This interpretation also gives meaning to the requirement of Section 15F(h)(5)(A)(i)(VII) concerning "employee benefit plans subject to ERISA." Although these benefit plans are not ECPs within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of the Commodity Exchange Act, they are included in the category of plans identified as special entities in Exchange Act section 15F(h)(2)(C). For these reasons, we believe Rule 15Fh-5(a) should apply to any special entity as counterparty.

Application to Offers

The Commission continues to believe that, consistent with statutory language, the independent representative requirement of the business conduct rules should be triggered when an "offer" to enter into a security-based swap is made. We disagree with the commenter that applying Rule 15Fh-5(a) at the offer stage is premature.[871] The rules are intended to provide benefits to special entities by, among other things, requiring that a special entity has a qualified independent representative that undertakes a duty to act in

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869 See Ropes & Gray, supra note 5.

870 See Proposing Release, 76 FR at 42426, supra note 3. See also H.R. Conf. Rep. 111-517 (Jun. 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).

871 See APPA, supra note 5.

its best interests in determining whether to enter into a security-based swap. The benefits of these protections could be lost if the rule were to require only that the special entity counterparty have an independent representative at the time the transaction is executed.[872]

Some commenters argued that the appropriate definition of the term "offer" should be consistent with contract law, and that a communication should only be considered an offer when, based on the relevant facts and circumstances, it is "actionable" or "firm."[873] The Commission agrees with the commenter that the term "offer" for purposes of the independent representative requirement of these business conduct rules means an "offer to enter into a security-based swap that, if accepted, would result in a binding contract under applicable law."[874] Given that the relationship between the SBS Entity and the counterparty is defined and shaped by contract (e.g., generally a master agreement and credit documents), we believe that the contractual interpretation is the appropriate interpretation in this context. This interpretation is also the same as the CFTC's interpretation of an offer to enter into a swap and would harmonize the scope of the term offer for purposes of the independent representative requirement of these business conduct rules.[875] We believe that this harmonization will result in efficiencies for entities that have already established infrastructure to comply with the CFTC standard.

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872 Id.

873 See FIA/ISDA/SIFMA, supra, note 5. See also SIFMA (August 2015), supra note 5.

874 See SIFMA (August 2015), supra note 5.

875 See CFTC Adopting Release at 9741.

Whether preliminary negotiations would be deemed an "offer" will depend upon the facts and circumstances and details of the communication.[876] For example, if the preliminary communication contains enough details (or if taken in the context of several communications) that, if accepted, would result in a binding contract, it likely may be an "offer" under the rule.

Reasonable Basis

The Commission recognizes and believes it appropriate that Rule 15Fh-5(a) imposes on SBS Entities a duty of inquiry to form a reasonable basis to believe the special entity has a qualified independent representative. The amount of due diligence the SBS Entity must perform to form a reasonable basis to believe the independent representative meets a particular qualification will depend upon the particular facts and circumstances. For example, if the SBS Entity has no prior dealings or familiarity with the particular independent representative, it will likely require more diligence on the part of the SBS Entity than a transaction with an independent representative that the SBS Entity has had numerous recent dealings in various different contexts. Furthermore, if the SBS Entity has dealt with the independent representative in other contexts, but not necessarily in the context of a security-based swap, it may require some limited diligence to form a reasonable basis regarding the requisite qualifications.

The Commission agrees, however, with the concerns of commenters that requiring SBS Entities to perform substantial due diligence regarding the qualifications of independent representatives may provide SBS Entities with the ability to second guess or negate the special entity's choice of independent representative, which may generally

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[876] See FIA/ISDA/SIFMA, supra, note 5.

increase transaction costs for security-based swaps with special entities, and allow SBS Entities to exert undue influence over the special entity's selection of an independent representative.[877] To address these concerns, final Rule 15Fh-1(b), as discussed in Section II.D, allows SBS Entities to reasonably rely on written representations regarding the qualifications and independence of special entities' representatives.[878] This generally comports with an SBS Entity's heightened standard of care when transacting with special entities, while avoiding the potential conflict of interest and increased transaction costs that could result if SBS Entities effectively second-guessed special entities' choice of independent representatives. In addition, we are adopting safe harbors as discussed below, pursuant to which an SBS Entity will be deemed to have a reasonable basis to believe that the special entity has a representative that meets the qualification and independence requirements of Rule 15Fh-5(a). We believe the availability of the safe harbor also addresses the concerns of certain commenters that SBS Entities not exert undue influence on the special entity's selection of representative.[879]

The Commission acknowledges one commenter's recommended approach that would permit a special entity to choose between either: (1) relying on the Commission's proposed framework regarding a reasonable basis to believe the qualifications of the independent representative; or (2) relying on an alternative approach under which it would be permitted to enter into off-exchange security-based swap transactions with an SBS Entity if the special entity had a representative, whether internal or a third party, that

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877 See MFA, supra note 5; GFOA, supra note 5.

878 See Rule 15Fh-1(b).

879 See e.g., CalPERS (August 2011) supra note 5.

had been certified as able to evaluate security-based swap transactions. The commenter contemplated that the certification process would involve the development and implementation of a proficiency examination by the Commission or FINRA "or another recognized testing organization," and that a certified independent representative would be required to complete periodic continuing education.[880] We do not believe that this suggested alternative would appropriately provide the protections to special entities that the statute and our proposed Rule 15Fh-5 were designed to provide. First, we believe that this alternative would effectively permit special entities to opt out of the express protections that the rules are intended to provide. In addition, we are not aware of the existence of a certification process as described by the commenter, and we did not propose and are not adopting such a process.[881]

As with final Rule 15Fh-2(a), we have determined to adopt Rule 15Fh-5(a) in a bifurcated format to avoid potential conflict with ERISA and DOL regulations, as well as to more closely harmonize with existing CFTC business conduct rules. Rule 15Fh-5(a)(1), as adopted, requires an SBS Entity that offers to enter into or enters into a security-based swap with a special entity other than an ERISA special entity to form a reasonable basis to believe that the special entity has a qualified independent representative. Rule 15Fh-5(a)(2), as adopted, requires an SBS Entity that offers to enter into or enters into a security-based swap with an ERISA special entity to have a reasonable basis to believe that the special entity has a fiduciary, as defined in Section 3

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880 See CalPERS, supra note 5.

881 However, to the extent that such a proficiency examination were created, the results of the examination could inform the SBS Entity's assessment of the qualifications of the independent representative.

of ERISA. By adopting separate criteria for the independent representatives of ERISA and non-ERISA special entities, the Commission is addressing the concerns of numerous commenters that the business conduct standards, if adopted without regard for the potential regulatory intersections of ERISA, could cause confusion and unintended consequences for SBS Entities dealing with ERISA plans.[882] In addition, this change will provide greater consistency with the parallel CFTC rule, which will result in efficiencies for SBS Entities that have already established infrastructure to comply with the CFTC rule.

The newly bifurcated rule, detailing the requisite criteria for an SBS Entity to form a reasonable basis to believe that ERISA and non-ERISA special entities have qualified independent representatives, is discussed in greater detail below.

b. Qualified Independent Representative

i. Proposed Rule

Proposed Rule 15Fh-5(a)(6) would require an SBS Entity to have a reasonable basis to believe that, in the case of a special entity that is an employee benefit plan subject to ERISA, the independent representative was a "fiduciary" as defined in section

882 See Section I.D., supra. See also ABC, supra note 5; FIA/ISDA/SIFMA, supra note 5; IDC, supra note 5; MFA, supra note 5; BlackRock, supra note 5; Johnson, supra note 5.

3(21) of that Act (29 U.S.C. 1002).[883] The proposed rule was not intended to limit, restrict, or otherwise affect the fiduciary's duties and obligations under ERISA.[884]

The Proposing Release solicited feedback regarding any specific requirements that should be imposed on SBS Entities with respect to this obligation, as well as what other independent representative qualifications might be deemed satisfied if an independent representative of an employee benefit plan subject to ERISA, is a fiduciary as defined in section 3 of ERISA.

ii. Comments on the Proposed Rule

The Commission received six comment letters advocating a presumption of qualification for ERISA plan fiduciaries, since ERISA already imposes fiduciary duties upon the person who decides whether to enter into a security-based swap on behalf of an ERISA plan, and imposes on this person a statutory duty to act in the best interests of the plan and its participants, thereby prohibiting certain self-dealing transactions.[885] According to these commenters, the Commission's proposed standards would be unnecessary, redundant, would overlap with ERISA's standards, and would only serve to

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883 See Section 15F(h)(5)(A)(i)(VII) of the Exchange Act, 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.

884 See notes 99, 198 and 189, supra regarding the DOL's proposal to amend definition of "fiduciary" for purposes of ERISA.

885 See ABA Committees, supra note 5; ABC, supra note 5; BlackRock, supra note 5; Mason, supra note 5; SIFMA (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

increase the administrative burden and cost on SBS Entities without any corresponding benefit.[886]

To address the potential conflict with ERISA standards, one commenter suggested that the Commission's definition of "independent representative" should be inapplicable to ERISA plans, and that the Commission should merely cross-reference the requirements under ERISA for ERISA representatives.[887]

Another commenter supported the presumptive qualification for ERISA plan fiduciaries, provided that the plan satisfied a minimum $1 billion net asset requirement for institutional investor organizations.[888] The commenter asserted that no public policy objective would be achieved by permitting an SBS Entity to reject a risk manager fiduciary selected by a sophisticated institutional investor organization with over $1 billion in net assets, which did not require the protections of the rules.[889]

Since the adoption of the CFTC's final rules, another commenter recently advocated for the separate treatment of independent representatives of special entities subject to ERISA.[890] Under this commenter's proposal, an SBS Entity that transacts with a special entity subject to Title I of ERISA must have a reasonable belief that the qualified independent representative is a fiduciary, as defined in Section 3 of ERISA.[891] An SBS Entity that transacts with a non-ERISA special entity would be required to form

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886 See ABC, supra note 5; BlackRock, supra note 5; Mason, supra note 5.

887 See ABC, supra note 5.

888 See ABA Committees, supra note 5.

889 Id.

890 See SIFMA (August 2015), supra note 5.

891 Id.

a reasonable belief that the special entity has a qualified independent representative, defined by specific criteria. The commenter's proposed modification recognizes "the unique fiduciary regime already applicable to such special entities," and harmonizes the Commission's criteria for qualified independent representatives with those of the CFTC.[892]

iii. Response to Comments and Final Rule

After consideration of the comments, the Commission is reformulating the rules to reflect a separate treatment for transactions with special entities subject to ERISA, and transactions with special entities other than those subject to ERISA. Toward this end, we have bifurcated Rule 15Fh-5(a) into parts (a)(1) (applicable to dealings with special entities other than those subject to ERISA), and (a)(2) (applicable to dealings with special entities subject to ERISA).

Under Rule 15Fh-5(a)(1), as adopted, an SBS Entity that transacts with a special entity that is not subject to ERISA must have a reasonable basis to believe that the special entity has a qualified independent representative. As defined in the rule, a qualified independent representative is a representative who: has sufficient knowledge to evaluate the transaction and risks; is not subject to a statutory disqualification; undertakes a duty to act in the best interests of the special entity; 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 the appropriateness of the security-based swap; in the case of a special entity defined in 15Fh-2(2) or (5), is subject to pay to play rules of the Commission, the CFTC, or a SRO

[892] Id.

subject to the jurisdiction of the Commission or the CFTC; and is independent of the SBS Entity. These qualifications are addressed, separately, in Section II.H.7, infra.

Under new Rule 15Fh-5(a)(2), (formerly proposed Rule 15Fh-5(a)(6)), an SBS Entity that transacts with a special entity subject to ERISA must have a reasonable basis to believe that the special entity has a representative that is a fiduciary, as defined in Section 3 of ERISA.[893] In this regard, the SBS Entity need not undertake further inquiry into the ERISA fiduciary's qualifications. Such a presumption is based on the pre-existing, comprehensive federal regulatory regime governing ERISA fiduciaries.[894]

The Commission agrees with commenters that ERISA fiduciaries should be presumptively deemed qualified as special entity representatives,[895] particularly because an ERISA fiduciary is already required by statute and regulations to, among other things, act with prudence and loyalty when evaluating a transaction for an ERISA plan.[896] Moreover, as several commenters noted, to overlap existing ERISA standards with the business conduct standards would be unnecessary, redundant, and would unnecessarily increase administrative costs for SBS Entities.[897]

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893 29 U.S.C. 1002.

894 See 29 U.S.C. 1001 et seq.; History of EBSA and ERISA, available at http://www.dol.gov/ebsa/aboutebsa/history.html.

895 See ABA Committees, supra note 5; ABC, supra note 5; BlackRock, supra note 5; Mason, supra note 5; SIFMA (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

896 See supra notes 786 and 799 and accompanying text.

897 See ABC, supra note 5; BlackRock, supra note 5; Mason, supra note 5.

This bifurcated rule is designed to address the commenter's concerns regarding the need to align the Commission's treatment of ERISA plans with that of the CFTC,[898] and will reflect the potential intersection of the business conduct rules with the comprehensive framework of regulation under ERISA. Specifically, as discussed above in Section I.D., supra, the bifurcated format of the rule addresses the concerns of numerous commenters that the intersection between ERISA's existing fiduciary regulation and the business conduct standards could lead to conflict and unintended consequences for SBS Entities transacting with ERISA special entities, up to and including the preclusion of ERISA plans from participating in security-based swap markets in the future.[899] By providing separate means for SBS Entities to comply with the rules when transacting with ERISA and non-ERISA special entities, the final rule will avoid the potential conflict between the comprehensive framework of regulation under ERISA and business conduct rule regimes.

However, the Commission declines the commenter's suggestion to exclude ERISA plans with a minimum net asset requirement from the requirements of the rule.[900] Rule 15Fh-5 is designed to ensure that special entities are represented by a qualified independent representative pursuant to the statutory requirement. The Commission does not believe that it is appropriate in this context to provide an exception to ERISA plans from the protections of representation by a qualified and independent representative based on a net asset threshold. Different entities will have differing levels of

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898 See SIFMA (August 2015), supra note 5.

899 See, e.g., ABC, supra note 5; FIA/ISDA/SIFMA, supra note 5; IDC, supra note 5; MFA, supra note 5; BlackRock, supra note 5; Johnson, supra note 5.

900 See ABA Committees, supra note 5.

understanding of the security-based swap market, which may or may not be impacted by the amount of their net assets. More generally, the rules are intended to provide certain protections to special entities, and we think it appropriate to apply the rules so that special entities receive the benefits of those rules.

c. Definition of "Independent Representative"

i. Proposed Rule

As noted above, an SBS Entity must have a reasonable basis to believe that a special entity has a "qualified independent representative." Proposed Rule 15Fh-2(c) would establish parameters for the term "independent representative" of a special entity.

For instance, proposed Rule 15Fh-2(c)(1) would generally require that a representative of a special entity 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. In the Proposing Release, the Commission noted that the SBS Entity should obtain the necessary information to determine if, in fact, a relationship existed between the SBS Entity and the independent representative that could impair the independence of the representative in making decisions that affect the SBS Entity.

Proposed Rule 15Fh-2(c)(3) would deem a representative of a special entity to be independent of an SBS Entity where two conditions are satisfied: (i) the representative is not and, within one year, was not an associated person of the SBS Entity; and (ii) the representative had 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. It was intended to encompass situations where a representative was hired by the special entity as a result of a recommendation by the SBS Entity. The restriction would also apply to revenues received, directly or indirectly, from associated persons of the SBS Entity.

In order for an SBS Entity to reasonably believe that the independent representative received less than ten percent of its gross revenue over the past year from the SBS Entity, the Commission noted that the SBS Entity would likely need to obtain information regarding the independent representative's gross revenues from either the special entity or independent representative.

ii. Comments on the Proposed Rule

Independence from the Special Entity

The Commission requested comment on whether an independent representative must be independent of the special entity entering into the security-based swap, or whether the representative need only be independent of the SBS Entity. All five commenters agreed that the independent representative need only be independent from the SBS Entity, and emphasized that the intent of the proposed rule was to ensure a special entity received advice from someone in no way affiliated with an SBS Entity.[901]

One commenter, representing two trade associations for municipal power producers, argued that the intended benefit of the proposed independent representative

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[901] See APPA, supra note 5; Ropes & Gray, supra note 5; BlackRock, supra note 5; GFOA, supra note 5; ABA Committees, supra note 5.

requirement was to ensure that a special entity receives security-based swap advice from a person other than the SBS Entity – not to force special entities to hire third-parties as independent representatives.[902] The commenter noted that although many municipal power producers rely on third-party advisors when entering interest-rate swaps, they have internal experts to advise them on energy contracts.

Another commenter asserted that the legislative history for Dodd-Frank indicated that a representative's "independence" referred to its independence from the dealer or broker – not its independence from the special entity.[903] The commenter pointed out that Congress specifically recognized the possibility that special entities would use an in-house risk specialist, and that the proposed rules seemed to incorporate this assumption.[904]

Standards for "Independence"

The Commission solicited comment regarding whether to adopt a different test for a representative's independence, or whether the definition of "independent representative" should exclude certain categories of associated persons. Eleven comment letters addressed the independence test in proposed Rule 15Fh-2(c)(2)-(3).[905]

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902 See APPA, supra note 5.

903 See ABA Committees, supra note 5.

904 Id.

905 See ABC, supra note 5; NABL, supra note 5; NAIPFA, supra note 5; AFSCME, supra note 5; Better Markets (August 2011), supra note 5; CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; APPA, supra note 5; BlackRock, supra note 5; SIFMA (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

Four commenters argued that the proposed rule would not sufficiently ensure a representative's independence.[906] For instance, one commenter suggested that the one-year prohibition on a representative being an associated person of the SBS Entity be extended to two years.[907] This commenter also recommended that representatives who receive any compensation of any kind, directly or indirectly, from an SBS Entity during the prior year be disqualified.[908] According to this commenter, representatives and associated persons should be barred from, directly or indirectly, working for or receiving compensation from any SBS Entities for one year to act as an independent representative for any special entity.[909]

Another commenter argued that under the proposed rule, a representative might be deemed to be independent even if he or she "worked with the SBS Entity as recently as a year ago, was recommended by the SBS Entity, has a direct business relationship with the SBS Entity that makes the representative highly financially dependent on that entity, and earns more of its revenues from the SBS Entity than from the Special Entity he or she purports to represent."[910] This commenter also noted that, under the proposed rule, a representative could earn virtually all of its gross revenues from various SBS Entities, so long as no more than ten percent originated from the entity on the other side of the transaction. For these reasons, the commenter urged the Commission to adopt

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906 See AFSCME, supra note 5; Better Markets (August 2011), supra note 5; CFA, supra note 5; NAIPFA, supra note 5.

907 See Better Markets (August 2011), supra note 5.

908 Id.

909 Id.

910 See CFA, supra note 5.

instead the version of the independence standard proposed by the CFTC, under which a representative would be deemed to be independent if: "(1) the representative is not and, within one year, was not an associated person of the swap dealer or major swap participant, within the meaning of Section 1a(4) of the Act; (2) there is no principal relationship between the representative of the Special Entity and the swap dealer or major swap participant; and (3) the representative does not have a material business relationship with the swap dealer or major swap participant, provided however, that if the representative received any compensation from the swap dealer or major swap participant, the swap dealer or major swap participant must ensure that the Special Entity is informed of the compensation and the Special Entity agrees in writing, in consultation with the representative, that the compensation does not constitute a material business relationship."[911]

Similarly, since the adoption of the CFTC's final business conduct rules, one commenter has argued that the Commission should harmonize its standards of independence with those of the CFTC, replacing the SEC's restriction on revenues received by the independent representative from the SBS Entity with the following qualifications: (1) the representative is not, and within one year of representing the special entity in connection with the security-based swap, was not an associated person of the SBS Entity; (2) there is no principal relationship between the special entity's representative and the SBS Entity; (3) the representative provides timely and effective disclosures to the special entity of all material conflicts of interest, complies with policies

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911 See Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 FR 80638, 80660 (Dec. 22, 2010) ("CFTC Proposing Release").

and procedures designed to mitigate conflicts of interest, is not directly or indirectly controlled by the SBS Entity, and does not receive referrals, recommendations, or introductions from the SBS Entity within one year of representing the special entity in connection with the security-based swap.[912] As the commenter asserted, "the CFTC's standard has, in our members' experiences, proved sufficient to ensure the independence of special entity representatives and mitigate possible conflicts of interest, while also establishing an objective standard that special entities can apply in practice. As a result, we believe harmonization would achieve the proposed rules' intended objective while also minimizing the extent to which SBS Entities and special entities need to incur significant additional costs."[913]

A third commenter suggested that the Commission revise the independence test for special entity representatives by: (1) using ERISA standards in assessing the independence of a representative (but rejecting the DOL's fiduciary standard, under which a fiduciary may not derive more than 1% of its annual income from a party in interest and its affiliates); (2) considering a representative's relationships with an SBS Entity on behalf of multiple special entities, including the representative's relationships with an SBS Entity outside of the security-based swap transaction at issue; (3) including the revenues of an independent representative's affiliates in applying the gross revenues test; (4) decreasing the ten-percent gross revenue threshold; and (5) adopting a two-year timeframe (rather than one year) to determine whether a representative is independent of

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912 See SIFMA (August 2015), supra note 5.

913 Id.

the SBS Entity.[914] The commenter argued that an independent representative should be permitted to receive compensation from the proceeds of a security-based swap, so long as the compensation was authorized by, and paid at the written direction of, the special entity.[915] However, the commenter did not believe that a special entity should be allowed to consent to an independent representative's conflicts of interest, even if fully disclosed, as such conflicts might still affect the independence of the representative.[916]

The sole commenter that supported the independence test as proposed did so on the grounds that market participants would benefit from the certainty of its safe harbor.[917]

Another commenter argued that the proposed rules' definition of "independent representative" should not apply to ERISA plans, as ERISA already defines the criteria for "independence" of a representative.[918] According to this commenter, if a plan's representative is not independent of the plan's counterparty, the transaction violates the prohibited transaction rules under ERISA section 406(b). Rather than adopt such overlapping regulations, the commenter suggested cross-referencing the independence requirements under ERISA. Otherwise, the prohibition on investment managers who receive revenues from SBS Dealers from serving as independent representatives could cause plans to lose their best investment managers and counterparties. Moreover, the

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914 See NAIPFA, supra note 5.

915 Id.

916 Id. Nor did the commenter believe that an SBS Entity should be required to have a reasonable basis to believe that the representative would make the appropriate and timely disclosures of any potential conflicts of interest.

917 See NABL, supra note 5.

918 See ABC, supra note 5.

commenter argued that "the administrative burden of applying the gross revenue test could in many cases be enormous at best and simply unworkable at worst."[919]

However, the majority of commenters urged the Commission to modify the proposed independence standards. For instance, while one commenter supported the Commission's one-year prohibition on associated persons of SBS Entities serving as special entity representatives, the commenter suggested four changes to the gross revenues component of the proposed rule: (1) only payments by or on behalf of the SBS Entity (not by or on behalf of any affiliates or other associated persons) should be taken into account; (2) the revenue computations should be based on the representative's prior fiscal year rather than a rolling twelve-month look-back to simplify the calculations and reduce compliance costs; (3) payments to any affiliate (other than a wholly-owned subsidiary) of the representative should not be taken into account for purposes of this test; and (4) an SBS Entity should be able to rely on representations from the representative as to its gross revenues and whether payments that have been made to the representative equal or exceed the ten percent threshold.[920]

Another commenter proposed reducing the one year disqualification period for association with the SBS Entity to six months.[921] This commenter also suggested excluding from the gross revenue test: (1) income from referrals from the gross revenue

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919 Id.

920 See FIA/ISDA/SIFMA, supra note 5.

921 See APPA, supra note 5.

test, because referrals "can be difficult to track;" and (2) income paid by an SBS Entity on behalf of the special entity.[922]

A third commenter generally opposed the proposed rule on the basis that it was unclear, would require costly enhancements to compliance systems, and "would be particularly problematic in instances where a corporate transaction changes the identity of associated persons during the look-back year."[923] With respect to the first prong of the proposed rule, this commenter supported eliminating the one-year look back period, as it believed the costs of compliance with that provision would outweigh any benefits. Instead, the commenter argued that "independence" should be established if the representative is not an associated person of an SBS Entity at the time of the transaction.[924] With respect to the gross revenue test, the commenter argued that the term "indirect compensation" was vague, and that "determining what would comprise indirect compensation and establishing a compliance system to track that indirect compensation represents a significant and time consuming burden," the expense of which would likely be passed on to special entities.[925] The commenter therefore suggested limiting the gross revenue test to direct revenue received by the representative from the SBS Dealer –and not its affiliates.[926]

A fourth commenter objected to the compliance burdens raised by the proposed rule, as well as various implementation concerns on the grounds that both prongs of the

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922 Id.

923 See BlackRock, supra note 5.

924 Id.

925 Id.

926 Id.

test were "moving targets" that would substantially complicate compliance and impose additional burdens and costs on advisors and special entities.[927] The commenter recommended that the Commission eliminate the twelve-month "look-back" provision altogether, but argued that if the Commission retained this provision, it should apply only where a continuing agreement exists between the representative and the SBS Entity (such as an ongoing corporate services agreement), that the one-year period be defined as a calendar year rather than a rolling twelve-month period, and that it should only be triggered by the SBS Entity and the representative – not by any associated persons of the SBS Entity or the representative.[928] This commenter additionally urged the Commission to eliminate the gross revenue test on the grounds that it was unduly restrictive and difficult to apply. However, if the Commission retained the gross revenue test, the commenter requested that the final rule clarify how gross revenues are to be calculated.[929]

Another commenter argued that the final version of proposed Rule 15Fh-2(c) clarify that the ten percent gross revenue test would not apply to any independent representative employed by the special entity, as such a prohibition would be inappropriate.[930] The commenter also suggested that the prohibition on independent representatives who have worked for an SBS Entity within the past year should not apply if the independent representative is an employee of the special entity, who owes the special entity a fiduciary duty.[931] The commenter asserted that if an independent

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927 See SIFMA (August 2011), supra note 5.

928 Id.

929 Id.

930 See ABA Committees, supra note 5.

931 Id.

representative is an employee of and owes a fiduciary duty to an institutional investor organization, an SBS Entity should have no authority to assess the representative's qualifications. The commenter pointed out that, as a fiduciary, the employee's prior employment by an SBS Entity would be irrelevant – since any actual breach of fiduciary duty would be governed by the special entity's charter, state law or other applicable legal requirements, rather than the Dodd-Frank Act.[932]

iii. Response to Comments and Final Rule

After consideration of the comments, the Commission is adopting Rule 15Fh-2(c), with certain modifications. First, we moved the rule defining the "independence" of a special entity's representative from Rule 15Fh-2 to Rule 15Fh-5 in an effort to minimize confusion, and to consolidate the requirements of the qualified independent representative into Rule 15Fh-5. Specifically, the Commission is renumbering proposed Rule 15Fh-2(c) as Rule 15Fh-5(a)(1)(vii). In doing so, we have subsumed the requirement that a representative be independent of the SBS Entity under the criteria for a special entity's qualified independent representative.

Consistent with our proposal and with comments received, we continue to believe that a qualified independent representative should be independent of the SBS Entity, but need not be independent of the special entity itself.[933] We do not believe that special entities would receive any greater protection by being required to incur the cost of retaining a representative that was independent of the special entity; in fact, the special entity may be better served by someone who has an ongoing relationship with it and is

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932 Id.

933 See Proposing Release, 76 FR at 42426, supra note 3. See also APPA; Ropes & Gray, supra note 5; and BlackRock, supra note 5.

more familiar with the uses of the proceeds of the swap and other needs of the special entity. Although the Dodd-Frank Act is silent concerning the question of independence from the special entity, nothing in the Dodd-Frank Act precludes the use of a qualified independent representative that is affiliated with the special entity. Accordingly, Rule 15Fh-5(a)(1) only requires that the independent representative be independent of the SBS Entity to be a qualified independent representative.

We are adopting Rule 15Fh-5(a)(1)(vii) (formerly proposed Rules 15Fh-2(c)(1) and (2)) with one modification. Proposed Rule 15Fh-2(c)(1) defined an independent representative of a special entity, in part, as "independent of the security-based swap dealer or major security-based swap participant that is the counterparty to a proposed security-based swap." Rule 15Fh-5(a)(1)(vii) as adopted eliminates the phrase "that is the counterparty to a proposed security-based swap" from the definition. As described immediately below, this change is intended to reconcile the use of the term "qualified independent representative" in Rules 15Fh-5(a)(1) and 15Fh-2(a)(2) as adopted.

Specifically, Rule 15Fh-2(a)(2) as proposed and as adopted, under which an SBS Dealer may seek to establish that it is not acting as an advisor to a special entity, refers to the definition of "qualified independent representative" as defined in Rule 15Fh-5(a).[934] However, although the relevant part of the definition of the term "independent representative of a special entity" in proposed Rule 15Fh-2(c)(1) included the phrase "that is a counterparty to a proposed security-based swap," the requirements in Rule 15Fh-2(a)(2) (as proposed and as adopted) are not limited to transactions in which the

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[934] Specifically, Rule 15Fh-2(a)(2) requires, among other things, a written representation by the special entity that it "will rely on advice from a qualified independent representative as defined in [Rule] 15Fh-5(a)" (emphasis added).

SBS Dealer is a counterparty to the special entity with respect to the security-based swap. Thus, as noted, we are eliminating the phrase "that is the counterparty to a proposed security-based swap" in Rule 15Fh-5(a)(1)(vii) as adopted to reconcile the cross reference to the term "qualified independent representative" in Rule 15Fh-2(a)(2).

This change will not alter the scope of Rule 15Fh-5(a) as adopted, because that rule is only applicable to an SBS Entity acting as counterparty to a special entity. It will, however, align the definition of qualified independent representative with the scope of Rule 15Fh-2(a), which applies to recommended transactions whether or not the SBS Dealer is a counterparty to the recommended security-based swap. As a result, there must always be someone independent of the SBS Dealer reviewing any recommended security-based swap transaction on behalf of the special entity, whether or not the SBS Dealer making the recommendation is the counterparty to the transaction. Furthermore, the elimination of the phrase "that is the counterparty to a proposed security-based swap" in the rule as adopted will harmonize the rule more closely with the parallel CFTC requirement.

Under Rule 15Fh-5(a)(1)(vii)(A) as adopted, 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." Rule 15Fh-5(a)(1)(vii)(B) (as adopted) modifies the criteria for determining the independence of the representative that was proposed in proposed Rule 15Fh-2(c)(3) by replacing the ten percent gross revenues test with requirements for timely disclosures of all material conflicts of interest and a prohibition against referrals, recommendations or introductions

by the SBS Entity within one year of the representative's representation of the special entity. Under Rule 15Fh-5(a)(1)(vii)(B) as adopted, a representative of a special entity will be deemed to be independent of an SBS Entity if three conditions are met: (1) the representative is not and, within one year of representing the special entity in connection with the security-based swap, was not an associated person of the SBS Entity; (2) the representative provides timely disclosures to the special entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the special entity and complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest; and (3) the SBS Entity did not refer, recommend, or introduce the representative to the special entity within one year of the representative's representation of the special entity in connection with the security-based swap.

Rule 15Fh-5(a)(1)(vii)(B)(1) (formerly proposed Rule 15Fh-2(c)(2)) requires that the independent representative is not and was not an associated person of the SBS Entity "within one year of representing the special entity in connection with the security-based swap." One commenter agreed with the one-year time frame in this provision.[935] One commenter suggested that one year was not long enough and suggested a two-year look back[936] and another commenter suggested that one year was too long and suggested a six-month look back.[937] After consideration of the comments, the Commission continues to believe that an appropriate amount of time is necessary to "cool off" any association with

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935 See FIA/ISDA/SIFMA, supra note 5.

936 See CFA, supra note 5.

937 See APPA, supra note 5.

an SBS Entity before being considered independent of the SBS Entity, and believes that a one-year period between being an associated person of an SBS Entity and functioning as an independent representative is an appropriate amount of time. We disagree with the commenter that a shorter six-month look back would be appropriate, as we believe that a one-year cooling off period provides greater assurances of independence. At the same time, we do not want to unnecessarily place lengthy restrictions on a representative's ability to work as an independent representative or unnecessarily restrict a special entity's access to qualified independent representatives. For this reason, we believe that a one year restriction strikes an appropriate balance. In addition to the comments received, we note that many market participants have established compliance policies and procedures to address a one-year look-back to comply with the CFTC rule that requires that the independent representative was not an associated person of the Swap Entity within the preceding twelve months or the independent representative complied with policies and procedures reasonably designed to manage and mitigate the conflict of being an associated person within the last twelve months.[938]

Rule 15Fh-5(a)(1)(vii)(B)(2) adds the new requirement that a representative must provide timely disclosures to the special entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative regarding its obligations to the special entity, and the representative must comply with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest. This requirement establishes a standard that is designed to support the development of an SBS Entity's reasonable belief regarding the independence of the

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938 See CFTC Adopting Release, 77 FR at 9795, supra note 21.

representative advising a special entity. One commenter recommended adopting such a requirement, asserting that the CFTC standard, including the requirement for timely disclosures has, in their "members' experiences proved sufficient to ensure the independence of special entity representatives and mitigate possible conflicts of interest, while also establishing an objective standard that special entities can apply in practice."[939] In addition, harmonization with the parallel CFTC rule will result in efficiencies for SBS Entities that have already established infrastructure to comply with the CFTC rule.

In the Commission's view, to be "timely," a representative's disclosures must allow the special entity sufficient opportunity to assess the likelihood or magnitude of a conflict of interest prior to entering into the security-based swap.

To determine which conflicts of interest disclosures are required, an SBS Entity generally would need a reasonable basis to believe that the representative reviewed its relationships with the SBS Entity and its affiliates, including lines of business in which the representative solicits business. Additionally, where applicable, the SBS Entity generally would also need a reasonable basis to believe the representative reviewed the relationships of its principals and employees, who could affect the judgment or decision making of the representative on behalf of the special entity.

Lastly, Rule 15Fh-5(a)(1)(vii)(B)(3) replaces the proposed "gross revenues" test with a standard under which a representative will not be deemed independent if the SBS Entity refers, recommends, or introduces the representative to the special entity within one year of the representative's representation of the special entity in connection with the

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[939] See SIFMA (August 2015), supra note 5.

security-based swap. The change is intended to provide a simpler standard for achieving the policy goal that a special entity's choice of representative and the advice the representative provides should be made without any influence or input from the SBS Entity.

In making this modification to the rule as adopted, the Commission seeks to address commenters' concerns about cost, clarity, and practicality.[940] Commenters had expressed concerns regarding the gross revenues test and an SBS Entity's ability to accurately track the revenues.[941] One commenter suggested eliminating the gross revenues standard altogether.[942] After consideration of the comments, the Commission believes that the disclosures provided and the prohibition against referrals,

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940 See SIFMA (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5; APPA, supra note 5; BlackRock, supra note 5; and SIFMA (August 2015), supra note 5.

941 See SIFMA (August 2011), supra note 5 (expressing concerns about calculating a rolling twelve months of revenues and arguing that the ten percent threshold would create a revenue ceiling that is unduly restrictive and difficult to apply (e.g., a representative to multiple collective investment vehicles would be required to consider each of its multiple distributors for each collective investment vehicle as a source of indirect revenue)); FIA/ISDA/SIFMA, supra note 5 (arguing for clarification that (1) payments to or from affiliates of the SBS Entity or representative would not be taken into account; (2) revenue computations should be determined as of the end of the prior fiscal year; and (3) the SBS Entity may rely on representations from the representative as to its gross revenues and whether payments equal or exceed the ten percent threshold); APPA, supra note 5 (suggesting (1) elimination of income from referrals from the gross revenue test because referrals are difficult to track; and (2) gross revenues test should not take into account income paid by an SBS Entity on behalf of the special entity); BlackRock, supra note 5 (expressing concerns regarding what would comprise "indirect compensation" and the compliance systems to track it and arguing that revenue received from affiliates of the SBS Dealer should not be considered); and SIFMA (August 2015), supra note 5 (arguing for the replacement of the gross revenues test with the CFTC standard).

942 See SIFMA (August 2011), supra note 5; and SIFMA (August 2015), supra note 5.

recommendations or introductions adequately addresses concerns regarding independence more simply and directly than the proposed "gross revenues" test.[943] Furthermore, this prohibition harmonizes the Commission's standards for the independence of the representative with those of the CFTC.

6. Qualifications of the Independent Representative

Proposed Rules 15Fh-5(a)(1)(i) – (vii) would list the required qualifications of a special entity's independent representative. The qualifications would be that the independent representative: (1) has sufficient knowledge to evaluate a security-based swap and its risks; (2) is not subject to statutory disqualification; (3) will undertake 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 ERISA; and (7) is subject to the pay to play prohibitions of the Commission, the CFTC, or an SRO that is subject to the jurisdiction of the Commission or the CFTC. Each of these proposed qualifications is discussed in turn below.

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943 Although the independence safe harbor under Rule 15Fh-5(a)(vii)(B) does not include a gross revenues test, SBS Entities should consider whether the sources of revenues of a representative create a conflict of interest that must be disclosed pursuant to Rule 15Fh-5(a)(vii)(B)(2) or 15Fh-5(b) or otherwise impede the independence of the representative. Depending on the facts and circumstances, failure to disclose material conflicts of interest when there is a recommendation by a broker-dealer can be a violation of the antifraud rules. See, e.g., Chasins, 438 F.2d at 1172.

As discussed above in Section II.H.5.a.iii.B and more fully below, the rules as adopted will distinguish between transactions with special entities subject to ERISA, and transactions with special entities other than those subject to ERISA. Specifically, Rule 15Fh-5(a)(1) as adopted addresses the qualifications for the independent representatives of special entities other than those subject to regulation under ERISA, and Rule 15Fh-5(a)(2) as adopted addresses the qualifications for independent representatives of special entities subject to regulation under ERISA.

a. Written or Other Representations Regarding Qualifications

i. Proposal

In the Proposing Release, the Commission also requested comment regarding whether independent representatives must furnish written representations about their qualifications, or whether the rules should permit other means of establishing that a special entity's independent representative possessed the requisite qualifications.

ii. Comments on the Proposal

The Commission received three comment letters on this point, all in favor of a written representation requirement.[944] Although one such commenter agreed that written representations should be sufficient to ensure that a qualified independent swap advisor had been hired, the commenter proposed that the written representations include a verification that the external swap advisor had registered with and met professional standards set by the appropriate regulatory body overseeing swap advisors.[945] According to the commenter, this would provide for independent verification that was not associated

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944 See NAIPFA, supra note 5; GFOA, supra note 5; APPA, supra note 5.

945 See GFOA, supra note 5.

with the SBS Dealer or the special entity, thereby minimizing any potential conflict of interests.[946]

Another commenter suggested that, in the case of an internal representative, written representations should be obtained either from the representative or from the special entity, or a combination of the two, depending on the circumstances.[947] In the case of third-party representatives, the commenter suggested that the third-party representative provide the statement either directly to the SBS Entity or to the special entity acknowledging that the statement would be relied on by SBS Entities for purposes of the business conduct rules.[948]

iii. Response to Comments and Final Rule

After considering the comments, the Commission has determined not to mandate a manner of compliance with the requirements of Rule 15Fh-5(a). As discussed above, the obligation is on the SBS Entity to have a reasonable basis for believing that an independent representative has the necessary qualifications. An SBS Entity may use various means, such as reliance on representations from the special entity or its representative or due diligence, to form its reasonable basis to believe the special entity's independent representative meets the qualifications outlined in Rule 15Fh-5(a).

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946 Id.

947 See APPA, supra note 5.

948 Id. See also SIFMA (August 2015), supra note 5 (asserting that an SBS Entity should be deemed to have formed a reasonable basis to believe that a special entity has a qualified independent representative by relying on written representations that the representative is either an ERISA fiduciary, or that the representative satisfies the criteria for a qualified independent representative).

When an SBS Entity is relying on representations from a special entity or its representative to satisfy the requirements of the rule, the requirements of Rule 15Fh-1(b) will apply.[949] Consistent with our approach to representations used to make institutional suitability determinations, we believe that parties should be able to make representations regarding the knowledge and qualifications of the independent representative on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or broadly in terms of all potential transactions between the parties. However, where there is an indication that the independent representative is not capable of independently evaluating investment risks, or does not intend to exercise independent judgment regarding all of an SBS Entity's recommendations, the SBS Entity necessarily will have to be more specific in its approach. For instance, in some cases, an SBS Entity may be unable to determine that an independent representative is capable of independently evaluating investment risks with respect to any security-based swap. In other cases, the SBS Entity may determine that the independent representative is generally capable of evaluating investment risks with respect to some categories or types of security-based swaps, but that the independent representative may not be able to understand a particular type of security-based swap or its risk.

b. Sufficient Knowledge to Evaluate Transaction and Risks

i. Proposed Rule

[949] See discussion in Section II.D, supra.

Proposed Rule 15Fh-5(a)(1) would require an SBS Entity to have a reasonable basis to believe that the independent representative has sufficient knowledge to evaluate the security-based transaction and related risks.

ii. Comments on the Proposed Rule

The Proposing Release solicited comment regarding what circumstances, if any, would give rise to a presumption of qualification for certain independent representatives other than ERISA fiduciaries.

Presumptive Qualification

Two commenters supported a finding of presumptive qualification for sophisticated, professional advisers, such as banks, Commission-registered investment advisers, registered municipal advisors, or other similarly qualified professionals.[950] The commenter stated its view that applicable federal and/or state regulations governing these entities already impose requirements that ensure a minimum qualification level, and any additional evaluation of such representatives' qualifications would add little or no value to a special entity's representative selection process.[951]

Other commenters supported the presumption of qualification for in-house representatives of a special entity, since those representatives should presumably act in the best interests of the special entity by virtue of their employment with the special entity.[952] More specifically, one commenter supported this presumption on the grounds that the representative had been hired by the special entity to perform a hedging and risk

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950 See ABC, supra note 5; SIFMA (August 2011), supra note 5.

951 See SIFMA (August 2011), supra note 5.

952 See ABA Committees, supra note 5; NAIPFA, supra note 5; CalPERS, supra note 5; Ropes & Gray, supra note 5; APPA, supra note 5; GFOA, supra note 5.

control function, that he or she would be subject to direct control by his or her employer, and that he or she would be subject to regular review.[953] Another commenter supported this presumption so long as the in-house representative met established requirements for qualification, testing and continuing education.[954]

Similarly, one commenter supported the presumption of qualification for independent representatives where a governmental entity had verified the qualifications of its independent representative employee through the hiring process.[955]

Registration of Representative as Municipal Advisor or Investment Adviser

In the Proposing Release, the Commission asked whether to require that an independent representative be registered as a municipal advisor or an investment adviser or otherwise subject to regulation, such as banking regulation.[956] Three commenters expressed some support for the proposed registration requirement for independent representatives,[957] while one commenter opposed it.[958]

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953 See APPA, supra note 5.

954 See NAIPFA, supra note 5. NAIPFA did not support a presumption of qualification for "a sophisticated, professional adviser such as a bank, Commission-registered investment adviser, insurance company or other qualifying QPAM or INHAM for Special Entities subject to ERISA, a registered municipal advisor, or a similar qualified professional."

955 See GFOA, supra note 5.

956 See Proposing Release, 76 FR at 42429, supra note 3. Such registration would subject independent representatives to rules such as MSRB rules (for example, Notice 2011-04 Pay to Play Rules for Municipal Advisors) or other regulation (for example, 17 CFR 275.206(4)-5). See also Proposing Release, 76 FR at 42431 n.245-247, supra note 3.

957 See NAIPFA, supra note 5; GFOA, supra note 5; FIA/ISDA/SIFMA, supra note 5.

958 See APPA, supra note 5.

The first commenter supporting the registration requirement suggested that the written representations regarding a representative's qualifications include a verification that the external swap advisor had registered with and met professional standards set by the appropriate regulatory body overseeing swap advisors.[959]

Another commenter supported the requirement that independent representatives be registered with the Commission as municipal advisors or investment advisers, or that they otherwise be subject to regulation, such as banking regulations, under which the independent representative would be bound by a fiduciary duty of loyalty and care at all times.[960]

The third commenter requested that the Commission establish a safe harbor permitting an SBS Entity to conclude that the special entity's representative was "qualified" (but not necessarily "independent") if the representative was a registered municipal advisor or an SEC-registered investment adviser that provides investment advice with respect to security-based swaps (or a foreign entity having an equivalent status abroad).[961]

As noted above, one commenter opposed requiring employees of a special entity to register in any capacity, and suggested that any requirement to register third-party representatives should first be issued in the form of a notice of proposed rulemaking.[962]

Proficiency Examination

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959 See GFOA, supra note 5.

960 See NAIPFA, supra note 5.

961 See FIA/ISDA/SIFMA, supra note 5.

962 See APPA, supra note 5.

In the Proposing Release, the Commission requested comment regarding whether a proficiency examination should be developed to assess the qualifications of independent representatives. Four commenters supported the development and usage of a proficiency examination,[963] while one commenter opposed any proficiency examination for in-house representatives.[964]

One commenter, advocating for a proficiency examination, argued that such testing should be mandatory for both in-house and third-party representatives.[965] Another commenter suggested that the proficiency examination could be developed by the Commission, an SRO (e.g., FINRA), or another recognized testing organization.[966] Furthermore, after passing the examination, this commenter suggested that an independent representative be required to complete periodic continuing education.[967]

On the other hand, one commenter opposed any proficiency examination for in-house representatives, and argued that a proficiency exam for third-party representatives might provide a false sense of expertise.[968] This commenter also expressed concern that an examination requirement might, directly or indirectly, impose additional costs or burdens on special entities or SBS Entities.[969]

Periodic Re-Evaluation of Qualifications

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963 See CFA, supra note 5; CalPERS (August 2011), supra note 5; GFOA, supra note 5; NAIPFA, supra note 5.

964 See APPA, supra note 5.

965 See NAIPFA, supra note 5.

966 See CalPERS (August 2011), supra note 5.

967 Id.

968 See APPA, supra note 5.

969 Id.

In the Proposing Release, the Commission asked whether an SBS Entity should be required to reevaluate (or, as applicable, require a new written representation regarding) the qualifications of the independent representative on a periodic basis.

The Commission received three comment letters in response to the request for comment.[970] The first commenter viewed the reevaluation of a representative's qualifications as unnecessary if independent representatives were subject to continuing education and periodic testing requirements.[971] Another commenter suggested that the Commission permit the representations regarding a representative's qualifications to be set forth in a letter that could be relied on for the duration of a swap master agreement.[972] However, this commenter acknowledged a value in requiring periodic re-certification for third-party representatives, and recommended that such re-certification occur every two years.[973] The third commenter was concerned that trade-by-trade documentation of the independent representative criteria could reduce the speed of trade execution for special entities and add compliance burdens to each transaction.[974] This commenter requested that the Commission clarify that an SBS Dealer may meet its burden of confirming the qualifications of an independent representative through appropriate representations provided by the special entity no more frequently than annually.[975]

iii. Response to Comments and Final Rule

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970 See NAIPFA, supra note 5; APPA, supra note 5; Ropes & Gray, supra note 5.

971 See NAIPFA, supra note 5.

972 See APPA, supra note 5.

973 Id.

974 See Ropes & Gray, supra note 5.

975 Id.

Upon consideration of the comments, the Commission is adopting Rule 15Fh-5(a)(1)(i) (formerly proposed Rule 15Fh-5(a)(1)), as proposed.

Rule 15Fh-5(a)(1)(i) as adopted requires that SBS Entities have a reasonable basis to believe that the independent representative has sufficient knowledge to evaluate the transaction and risks. The independent representative may be required to register by the statutes and rules of another regulatory regime, such as municipal advisor or investment adviser, and nothing in the business conduct standards modifies or otherwise alters those registration requirements. Whether or not an independent representative is otherwise registered under a different regulatory regime may inform the SBS Entity's view of the independent representative's knowledge and qualifications, but would not automatically satisfy the qualification requirements of the independent representative. For example, an independent representative registered as an investment adviser may be very knowledgeable with respect to a variety of asset classes that do not include security-based swaps.

While some commenters supported the development of a proficiency examination, we are neither developing nor requiring that a proficiency examination be developed to assess the qualifications of independent representatives.[976] As noted above, an SBS Entity may reasonably rely on written representations about the qualifications of the independent representative to satisfy this obligation. In this regard, the Commission

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976 See CFA, supra note 5; CalPERS (August 2011), supra note 5; GFOA, supra note 5; NAIPFA, supra note 5.

believes that the framework of Rule 15Fh-5(a)(1) provides an appropriate criteria for assessing the qualifications of special entity representatives.[977]

As discussed below, we are separately providing in new Rule 15Fh-5(a)(2) that the qualified independent representative requirement will be satisfied if a special entity that is subject to regulation under ERISA has a representative that is a fiduciary as defined in Section 3 of ERISA. We recognize that Congress has established a comprehensive federal regulatory framework that applies to plans subject to regulation under ERISA.[978] Such recognition of the federal regulatory framework for ERISA plans maintains statutory protections for ERISA plans, while addressing the potential conflict, recognized by commenters, between the ERISA rules and business conduct standards adopted today.[979]

Commenters have suggested various time frames in which an independent representative's qualifications should be confirmed or recertified.[980] Whether or not an independent representative's qualifications should be periodically re-evaluated will likely be dependent on whether it is reasonable for the SBS Entity to continue to rely on the representations regarding the independent representative's qualifications. The Commission recognizes the potential benefit of requiring periodic re-evaluation, but is also mindful of the costs of doing so. The Commission has determined that it is

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977 However, as noted above in Section II.H.5., supra, to the extent a proficiency examination or certification process develops in the future, such examination or certification may inform an SBS Entity's reasonable basis to believe the qualifications of the independent representative.

978 See 29 U.S.C. 1104 and 1106.

979 See Section I.D. supra; see also CFTC Adopting Release, supra note 21.

980 See Ropes & Gray, supra note 5 (no more frequently than annually); and APPA, supra note 5 (recertified every two years).

appropriate to allow the SBS Entity to determine the necessity for a re-evaluation based on the reasonableness of its reliance on the representations it receives from the special entity regarding the qualifications of the independent representatives, which will provide the SBS Entities and the special entities with flexibility to address their particular facts and circumstances while still affording the special entities the protections of the rules.[981]

c. No Statutory Disqualification

i. Proposed Rule

Proposed Rule 15Fh-5(a)(2) would require an SBS Entity to have a reasonable basis to believe that an independent representative is not subject to a statutory disqualification. Although Exchange Act Section 15F(h) does not define "subject to a statutory disqualification," the term has an established meaning under Section 3(a)(39) of the Exchange Act,[982] which defines circumstances that would subject a person to a

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981 As discussed above in Section II.D, the question of whether reliance on representations would satisfy an SBS Entity's obligations under our business conduct rules will depend on the facts and circumstances of the particular matter. An SBS Entity can rely on a counterparty's written representations unless the SBS Entity has information that would cause a reasonable person to question the accuracy of the representation. Similar to our approach to the reasonableness of reliance of representations with respect to institutional suitability in Section II.G.4, information that might be relevant to this determination includes whether the independent representative has previously advised with respect to this type of security-based swap or been involved in the type of trading strategy, and whether the independent representative has a basic understanding of what makes the security-based swap distinguishable from a less complex alternative. If the SBS Entity knows that the security-based swap or trading strategy represents a significant change from prior security-based swaps that the independent representative has evaluated or knows that the representative lacks a basic understanding of what distinguishes the security-based swap from a less complex alternative, the SBS Entity generally should consider whether it can reasonably rely on the representations regarding the qualifications of the independent representative.

982 15 U.S.C. 78c(a)(39).

statutory disqualification with respect to membership or participation in, or association with a member of, an SRO. While Section 3(a)(39) would not literally apply here, the Commission proposed 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.

ii. Comments on the Proposed Rule

In the Proposing Release, the Commission solicited comment regarding whether it should 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 was subject to a statutory disqualification.

The Commission received two comment letters on this issue. To minimize the degree of diligence imposed on SBS Dealers, one commenter suggested requiring third-party representatives to affirm that they are not subject to statutory disqualification, are not under investigation, and are not listed on the publicly available databases described above.[983]

After the adoption of the CFTC's final rules, the Commission received one comment letter addressing the definition of "statutory disqualification in the Proposing Release."[984] This commenter stated that, although the statutory disqualification standards under the Exchange Act and the CEA differ somewhat, both cover comparable types of disqualifying events.[985] Therefore, requiring a dual registrant to apply different standards

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983 See APPA, supra note 5.

984 See SIFMA (August 2015), supra note 5.

985 Id.

for statutory disqualification "would impose substantial and duplicative diligence documentation, without material countervailing benefits."[986] To avoid this conflict, the commenter suggested including language to accommodate dually registered SBS Entities by establishing a safe harbor where they are deemed to have a reasonable basis to believe that a person is not subject to statutory disqualification under the Exchange Act if the dually registered SBS Entity has a reasonable basis to believe that the person is not subject to statutory disqualification under the CEA.[987] According to the commenter, this would allow dually registered SBS Entities to determine whether a special entity's representative is subject to statutory disqualification based on the information it obtained to ensure compliance with the parallel CFTC business conduct rule.[988]

iii. Response to Comments and Final Rule

The Commission is adopting proposed Rule 15Fh-5(a)(2), renumbered as Rule 15Fh-5(a)(1)(ii), as proposed, with one modification. The Commission is incorporating the definition of "statutory disqualification" under Section 3(a)(39)(A)-(F) of the Exchange Act, whereas the proposed rule incorporated the definition under Section 3(a)(39) of the Exchange Act.

Exchange Act Section 15F(h) does not define "subject to a statutory disqualification," however Exchange Act Section 3(a)(39) defines the term "statutory disqualification." As discussed in the SBS Entity Registration Adopting Release, the definition in Exchange Act Section 3(a)(39) specifically relates to persons associated

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986 Id.

987 Id.

988 Id.

with an SRO. In recognition of the fact that an independent representative of a special entity may not be associated with an SRO, we have modified the text of proposed Rule 15Fh-2(f) to reference Sections 3(a)(39)(A) – (F) of the Securities Exchange Act of 1934. This updated cross-reference incorporates the underlying issues that give rise to statutory disqualification without reference to SRO membership.[989]

In defining the phrase "subject to statutory disqualification," the Commission declines to reference any parallel provisions of the CEA.[990] The CFTC defines "statutory disqualification" under relevant sections of the CEA, without reference to parallel provisions of the Exchange Act. Therefore the inclusion of references to the CEA might lead to greater confusion and less certainty among market participants regarding what persons would be subject to statutory disqualification.

The Commission declines to adopt a commenter's suggestion to require third-party representatives to provide specific affirmations that they are not subject to statutory disqualifications, are not under investigation, and are not listed on publicly available databases as subject to a statutory disqualification. We do not believe that it is necessary or appropriate to prescribe in Rule 15Fh-5(a)(1)(ii) how an SBS Entity must form its reasonable basis to believe that the independent representative is not subject to a statutory disqualification; rather, the rule provides SBS Entities the flexibility to determine how

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989 See Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, Exchange Act Release No. 75611 (Aug. 5, 2015), 80 FR 48964 (Aug. 14, 2015) ("Registration Adopting Release").

990 In determining whether an SBS Entity has a reasonable basis to believe an independent representative is not subject to a statutory disqualification, the SBS Entity may reasonably rely on representations regarding the absence of a statutory disqualification. See Sections II.D. and II.H.6.a above.

best to meet their obligation. The SBS Entity may reasonably rely on representations regarding the qualifications of the independent representative to form its reasonable basis, but it is not required to do so. Nor is it required to obtain any specific representations or affirmations.

d. Undertakes a Duty to Act in the Best Interests of the Special Entity

i. Proposed Rule

Proposed Rule 15Fh-5(a)(3) would require an SBS Entity to have a reasonable basis to believe that the independent representative would undertake a duty to act in the best interests of the special entity.

ii. Comments on the Proposed Rule

The Commission requested comment regarding what circumstances, if any, would give rise to a presumption that an independent representative was acting in the best interests of the special entity. The Commission received seven comment letters supporting the presumption that certain representatives would act in the best interests of the special entity by virtue of their employment with the special entity or their status as fiduciaries.[991] According to these commenters, in-house representatives of a special entity should presumably act in the best interests of their special entity employer, particularly where their performance would be subject to the special entity's review and evaluation.[992]

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991 See ABA Committees, supra note 5; NAIPFA, supra note 5; CalPERS, supra note 5; Ropes & Gray, supra note 5; APPA, supra note 5; GFOA, supra note 5; SIFMA (August 2015), supra note 5.

992 See ABA Committees, supra note 5; NAIPFA, supra note 5; CalPERS, supra note 5; Ropes & Gray, supra note 5; APPA, supra note 5; GFOA, supra note 5.

iii. Response to Comments and Final Rule

As discussed in Section I.D., supra, the Commission has modified Rule 15Fh-5 to address the intersection of Dodd-Frank and ERISA regulation by distinguishing between non-ERISA special entities and ERISA special entities. With respect to non-ERISA special entities, under Rule 15Fh-5(a)(1), an SBS Entity must have a reasonable basis for believing that a non-ERISA special entity counterparty has a qualified independent representative that, among other things, undertakes a duty to act in the "best interests" of the special entity.[993] With respect to ERISA special entities, under Rule 15Fh-5(b)(2), the SBS Entity must have a reasonable basis to believe a special entity counterparty that is "subject to" regulation under ERISA has a representative that is a "fiduciary" as defined in Section 3 of ERISA. This bifurcated treatment of ERISA and non-ERISA special entities under Rule 15Fh-5(a) addresses the commenter's recommendation that the business conduct rules recognize the comprehensive federal regulatory framework that applies to plans that are subject to regulation under ERISA, as well as creates efficiencies for special entities that have already conformed their relationships with their representatives to satisfy the CFTC's qualification criteria.[994]

The Commission is adopting proposed Rule 15Fh-5(a)(3), renumbered as Rule 15Fh-5(a)(1)(iii), as proposed. The Commission agrees with commenters that an SBS Entity may rely on information about legal arrangements between the special entity and its representative to establish that the representative is obligated to act in the best interests of the special entity, including by contract, employment agreement, or other requirements

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993 Rule 15Fh-5(a)(1)(iii).

994 See SIFMA (August 2015), supra note 5.

under state or federal law. In addition, Rule 15Fh-5(b) provides safe harbors for forming a reasonable basis regarding the qualifications of the independent representative.[995] Specifically, part of the safe harbor is satisfied if the independent representative provides a written representation that it is legally obligated to comply with the applicable requirements in Rule 15Fh-5(a)(1) that describe the qualifications of the independent representative – including that it undertakes to act in the best interests of the special entity - by agreement, condition of employment, law, rule, or other enforceable duty. Given the relief provided by the safe harbor, at this time, the Commission does not believe a presumption is necessary regarding the reasonable belief of the SBS Entity relating to the undertaking of the independent representative to act in the best interests of the special entity.

e. Makes Appropriate and Timely Disclosures to Special Entity

i. Proposed Rule

Proposed Rule 15Fh-5(a)(4) would require an SBS Entity to have a reasonable basis to believe that the special entity's independent representative would make "appropriate and timely" disclosures to the special entity of material information concerning the security-based swap.

ii. Comments on the Proposed Rule

The Proposing Release solicited comment regarding whether to impose specific requirements with respect to the content of the disclosures in proposed Rule 15Fh-5(a)(4). The Commission received six letters addressing this provision of the proposed

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995 See Section II.H.6.g. below for a more detailed discussion of the safe harbor.

rule. Two commenters supported the use of specific disclosures to satisfy this requirement.[996] In contrast, two commenters argued that the Commission should not require specific content disclosures.[997] One commenter appeared to argue that the standard of the proposed rule was too low,[998] and two commenters cautioned against reading this portion of the proposed rule as requiring the disclosure of information before the execution of each trade.[999]

A commenter recommended that the final rules expressly state that the appropriate and timely disclosure requirement would be satisfied if the SBS Entity received a written representation affirming that the representative is "obligated by law and/or agreement or undertaking to provide appropriate and timely disclosures to the special entity."[1000] However, this commenter additionally believed that, because this provision of the proposed rule could be read to mandate pre-execution disclosure on a transaction-by-transaction basis, it could cause delays in the execution of security-based swaps, interfere with special entities' ability to hedge positions and portfolio risks, and deprive them of trading opportunities.[1001] Another commenter requested that the Commission clarify that proposed Rule 15Fh-5(a)(4) would not require the disclosure of information before a trade is executed.[1002]

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996 See ABC, supra note 5; SIFMA (August 2011), supra note 5.

997 See APPA, supra note 5.

998 See NAIPFA, supra note 5.

999 See BlackRock, supra note 5; SIFMA (August 2011), supra note 5.

1000 See SIFMA (August 2011), supra note 5.

1001 Id.

1002 See BlackRock, supra note 5.

A third commenter urged the Commission not to impose specific requirements regarding the content of the disclosures.[1003] According to this commenter, there are too many types of swaps and circumstances to allow for a uniform set of mandated disclosures.[1004] After the adoption of the CFTC's final rules, a commenter argued against the specific requirement that the qualified independent representative disclose "material information concerning the security-based swap."[1005] The commenter requested that the Commission instead make the requirement a general requirement to make appropriate and timely disclosures to the special entity to harmonize this provision with the parallel CFTC requirement, "which would reduce costs for special entities since most of them have already conformed their relationships with their representatives to satisfy the CFTC's qualification criteria."[1006]

iii. Response to Comments and Final Rule

As noted above, the SBS Entity may reasonably rely on representations regarding the independent representative making appropriate and timely disclosures to the special entity to form its reasonable basis to believe that the independent representative will comply with Rule 15Fh-5(a)(1)(iv). As with Rule 15Fh-5(a)(1)(iii), an SBS Entity may rely on appropriate legal arrangements between a special entity and its representative to form a reasonable basis to believe the representative will make appropriate and timely disclosures to the special entity of material information regarding the security-based swap – such as an existing contract or employment agreement.

1003 See APPA, supra note 5.

1004 Id.

1005 See SIFMA (August 2015), supra note 5.

1006 Id.

In response to the comments arguing that pre-trade disclosure should not be required, we believe the necessity of pre-trade disclosure will depend on the facts and circumstances of the particular security-based swap in the context of the special entity and independent representative. The SBS Entity is required to have a reasonable basis to believe the independent representative will provide the appropriate and timely disclosures. To the extent that any disclosures from the independent representative are necessary for the special entity to make an investment decision with respect to the security-based swap, the disclosure would not be timely if it was given after the investment decision was made. Similarly, the CFTC rule also requires that the Swap Entity have a reasonable basis to believe that the independent representative will make "appropriate and timely" disclosures. Although the language of the Commission's rule narrows the requirement found in the parallel CFTC rule to appropriate and timely disclosures of "material information concerning the security-based swap," the timing requirement is the same.[1007]

f. Pricing and Appropriateness

i. Proposed Rule

Proposed Rule 15Fh-5(a)(5) would require an SBS Entity to form a reasonable basis to believe that the special entity's independent representative would provide written representations to the special entity regarding fair pricing and the appropriateness of the security-based swap.

ii. Comments on the Proposed Rule

[1007] See Section II.H.5., supra.

Four commenters addressed this proposed rule. Two commenters supported the Commission's proposal that it "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."[1008] Both commenters urged the Commission to incorporate this approach into the adopted rules.

The third commenter suggested that an independent representative should be required to disclose the basis on which it determined that a particular transaction was fairly priced, and that the underlying documentation should be sufficiently detailed to enable a third party to evaluate the representative's conclusion.[1009]

After the adoption of the CFTC's business conduct rules, the fourth commenter urged the Commission to harmonize with the CFTC and require that the qualified independent representative "evaluate[], consistent with any guidelines provided by the special entity, regarding fair pricing and the appropriateness of the security-based swap."[1010] The commenter asserted that this harmonization would reduce compliance costs for special entities that have already conformed their relationships with their representatives to satisfy the CFTC's qualification criteria.[1011]

iii. Response to Comments and Final Rule

Upon consideration of the comments, the Commission is modifying proposed Rule 15Fh-5(a)(5), renumbered as Rule 15Fh-5(a)(1)(v). The Commission agrees with

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1008 See ABC, supra note 5; SIFMA (August 2011), supra note 5.

1009 See CFA, supra note 5.

1010 See SIFMA (August 2015), supra note 5.

1011 Id.

the commenter's suggestion that the Commission should harmonize with the language of the CFTC's parallel provision, which requires an SBS Entity to form a reasonable basis that the special entity's independent representative will "evaluate" fair pricing and the appropriateness of the security-based swap, "consistent with any guidelines provided by the special entity." In the Commission's view, requiring an SBS Entity to form a reasonable basis to believe that an independent representative will evaluate, consistent with any guidelines provided by the special entity, fair pricing and the appropriateness of the security-based swap will achieve the purpose of the proposed rule to ensure the special entity receives advice specifically with respect to pricing and whether or not to enter into the security-based swap. The rule will also provide the special entity the flexibility to provide parameters to its independent representative regarding the pricing and appropriateness of its security-based swap. The Commission therefore agrees with the commenter's suggestion that the special entity's guidelines, to the extent a special entity provides them, should establish the criteria for assessing the fair pricing and appropriateness of a security-based swap. In addition, this change will harmonize the rule with the parallel CFTC rule, thus creating efficiencies for entities that have already established infrastructure to comply with the CFTC standard. In the absence of any guidelines provided by the special entity, Rule 15Fh-5(a)(1)(v) requires the SBS Entity to form a reasonable basis to believe that the independent representative will evaluate the fair pricing and appropriateness of the security-based swap.

An SBS Entity also could form a reasonable basis for its determination by relying on a written representation that the independent representative will document the basis for its conclusion that the transaction was fairly priced and appropriate in accordance

with any guidelines provided by 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 special entity upon request.[1012] In response to commenters' concerns, the Commission clarifies that this provision does not necessarily require that a representative provide the special entity transaction-by-transaction documentation with respect to fair pricing and appropriateness of each security-based swap. For example, where the representative is given trading authority, the representative could consider undertaking in its agreement with the special entity to ensure that the representative will evaluate the pricing and appropriateness of each swap consistent with any guidelines provided by the Special Entity prior to entering into the swap. In such a situation, the independent representative could prepare and maintain adequate documentation of its evaluation of pricing and appropriateness to enable both the representative and the special entity to confirm compliance with any such agreement.

g. Subject to "Pay to Play" Prohibitions

i. Proposed Rule

Proposed Rule 15Fh-5(a)(7) would require an SBS Entity to have a reasonable basis to believe that a special entity's independent representative 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, unless the independent representative is an employee of the special entity.

[1012] Id.

While not addressed in the Dodd-Frank Act, the Commission proposed to include this "pay-to-play" provision among the qualifications for independent representatives.[1013] As discussed more fully in Section II.H.10 , infra, pay-to-play practices in connection with security-based swap transactions could result in significant harm to special entities – particularly where, as here, the independent representative is intended to act in the best interests of special entities.[1014] The pay-to-play provisions of the proposed rules were intended to deter independent representatives from participating, even indirectly, in such practices.

ii. Comments on the Proposed Rule

The Commission received one comment letter addressing the inclusion of a pay-to-play restriction among the qualifications for independent representatives. This commenter supported the exception to the pay-to-play restrictions for advisors who are employees of the special entity.[1015]

iii. Response to Comment and Final Rule

The Commission is adopting proposed Rule 15Fh-5(a)(7), renumbered as Rule 15Fh-5(a)(1)(vi), as proposed. Accordingly, an SBS Entity must have a reasonable basis for believing that the independent representative is subject to rules of the Commission,

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1013 See Exchange Act Section 15F(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, infra. See note 213, supra, and related text regarding an SBS Entity's reliance on a representation from the special entity to form this reasonable basis.

1014 See note 32, supra.

1015 See APPA, supra note 5. See also "Certain Political Contributions by SBS Dealers: Proposed Rule 15Fh-6" at Section II.D.4.a., infra.

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, unless the independent representative is an employee of the special entity.[1016] As stated in the Proposing Release, the Commission continues to believe that an independent representative in these circumstances would likely be either a municipal advisor or an investment adviser that is already subject to the MSRB's or the Commission's pay-to-play prohibitions. The Commission does 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. The Commission believes that Rule 15Fh-5(a)(1)(vi) will sufficiently deter SBS Entities from participating, even indirectly, in such unlawful practices.

h. ERISA Fiduciary

i. Proposed Rule

Proposed Rule 15Fh-5(a)(6) would require an SBS Entity to have a reasonable basis to believe that, in the case of a special entity that is an employee benefit plan subject to ERISA, the independent representative was a "fiduciary" as defined in section 3(21) of that Act (29 U.S.C. 1002).[1017] The proposed rule was not intended to limit,

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[1016] See Exchange Act Section 15B(e)(4), 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).

[1017] See Section 15F(h)(5)(A)(i)(VII) of the Exchange Act, 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.

restrict, or otherwise affect the fiduciary's duties and obligations under ERISA.[1018]

The Proposing Release solicited feedback regarding any specific requirements that should be imposed on SBS Entities with respect to this obligation, as well as what other independent representative qualifications might be deemed satisfied if an independent representative of an employee benefit plan subject to ERISA, is a fiduciary as defined in section 3 of ERISA.

ii. Comments on the Proposed Rule

The Commission received six comment letters advocating for a presumption of qualification for ERISA plan fiduciaries, since ERISA already imposes fiduciary duties upon the person who decides whether to enter into a security-based swap on behalf of an ERISA plan, and imposes on this person a statutory duty to act in the best interests of the plan and its participants, thereby prohibiting certain self-dealing transactions.[1019] According to these commenters, the Commission's proposed standards would be unnecessary, redundant, would overlap with ERISA's standards, and would only serve to increase the administrative burden and cost on SBS Entities without any corresponding benefit.[1020]

To address the potential conflict with ERISA standards, one commenter suggested that the Commission's definition of "independent representative" should be inapplicable

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1018 See notes 99, 198 and 189, supra, regarding the DOL's proposal to amend definition of "fiduciary" for purposes of ERISA.

1019 See ABA Committees, supra note 5; ABC, supra note 5; BlackRock, supra note 5; Mason, supra note 5; SIFMA (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

1020 See ABC, supra note 5; BlackRock, supra note 5; Mason, supra note 5.

to ERISA plans, and that the Commission should merely cross-reference the requirements under ERISA.[1021]

Another commenter supported the presumptive qualification for ERISA plan fiduciaries, provided that the plan satisfied a minimum $1 billion net asset requirement for institutional investor organizations.[1022] The commenter asserted that no public policy objective would be achieved by permitting an SBS Entity to reject a risk manager fiduciary selected by a sophisticated institutional investor organization with over $1 billion in net assets, which did not require the protections of the rules.[1023] Another commenter advocated for the separate treatment of independent representatives of special entities subject to ERISA.[1024] Under this commenter's proposal, an SBS Entity that transacts with a special entity subject to Title I of ERISA must have a reasonable belief that the qualified independent representative is a fiduciary, as defined in Section 3 of ERISA.[1025] The commenter's proposed modification for ERISA special entities was intended to recognize "the unique fiduciary regime already applicable to such special entities," and to harmonize the Commission's criteria for qualified independent representatives with those of the CFTC.[1026]

1021 See ABC, supra note 5.

1022 See ABA Committees, supra note 5.

1023 Id.

1024 See SIFMA (August 2015), supra note 5.

1025 Id.

1026 Id.

One commenter asserted that, for ERISA plans, the determination whether a disclosure was "appropriate" and "timely" should be made with reference to ERISA.[1027] However, in the event the Commission imposed its own, separate requirements on such disclosures, the commenter requested that the Commission allow the following representations to satisfy this provision of the proposed rule: (1) that the representative shall provide the special entity with such information, at such times, as the special entity may reasonably request regarding any swap trade (either individually or in the aggregate) entered into by such representative on behalf of the special entity; and (2) that, in the absence of specific instruction to the contrary by the special entity regarding swap trade disclosure, the representative shall comply with the disclosure requirements imposed on the representative under other applicable law (e.g., ERISA) and by the special entity under the special entity's investment management agreement and investment guidelines.[1028]

iii. Response to Comments and Final Rule

As discussed in Section II.H.5.b.iii, we are adopting a new Rule 15Fh-5(a)(2) that expressly addresses dealings with special entities subject to ERISA.

Under new Rule 15Fh-5(a)(2), (formerly proposed Rule 15Fh-5(a)(6)), an SBS Entity that acts as a counterparty to an employee benefit plan subject to Title I of ERISA must have a reasonable basis to believe that the special entity has a representative that is a fiduciary as defined in Section 3 of ERISA. In this regard, an ERISA fiduciary will be presumed to be a qualified independent representative, and the SBS Entity need not

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1027 See ABC, supra note 5.

1028 Id.

undertake further inquiry into the ERISA fiduciary's qualifications. Such a presumption acknowledges the pre-existing, comprehensive federal regulatory regime governing ERISA fiduciaries and the importance of harmonizing the Dodd-Frank Act requirements with ERISA to avoid unintended consequences.[1029] This formulation also will align the Commission's treatment of ERISA plans with that of the CFTC.

i. Safe Harbor

i. Summary of Comments

Although not included in the proposed rules, after adoption of the CFTC's final rules, one commenter requested that the Commission adopt separate safe harbors for transactions with ERISA and non-ERISA special entities regarding the requirement that an SBS Entity form a reasonable basis to believe that the special entity has a qualified independent representative.[1030] According to this commenter, the adoption of separate safe harbors for ERISA and non-ERISA special entities would align the Commission's requirements with those of the CFTC by recognizing the "unique fiduciary regime already applicable to" ERISA special entities, and, for transactions with non-ERISA special entities, the safe harbor would "help speed implementation, reduce costs, and mitigate counterparty confusion, because most special entity representatives have already taken steps to ensure that they can provide the representations contained in the CFTC's safe harbor."[1031]

ii. Response to Comments and Final Rule

1029 See Section I.D., supra.

1030 See SIFMA (August 2015), supra note 5.

1031 Id.

After consideration of the comments, the Commission has determined to add a new bifurcated safe harbor in Rule 15Fh-5(b), similar to that adopted by the CFTC. The Commission believes the safe harbor will provide SBS Entities an efficient manner with which to comply with the requirement to have a reasonable basis to believe an independent representative meets certain enumerated qualifications while meeting the purposes of the rule.

Under Rule 15Fh-5(b)(1) as adopted, an SBS Entity shall be deemed to have a reasonable basis to believe that a non-ERISA special entity has a representative that satisfies the requirements of Rule 15Fh-5(a)(1) if: (i) the special entity represents in writing to the SBS Entity that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the requirements of Rule 15Fh-5(a)(1), and that such policies and procedures provide for ongoing monitoring of the performance of such representative consistent with Rule 15Fh-5(a)(1); and (ii) the representative represents in writing to the special entity and the SBS Entity that the representative: has policies and procedures reasonably designed to ensure that it satisfies the requirements of Rule 15Fh-5(a)(1); meets the independence test of Rule 15Fh-f(a)(1)(vii); has the knowledge required under paragraph (a)(1)(i) of this section; is not subject to a statutory disqualification under paragraph (a)(1)(ii) of this section; undertakes a duty to act in the best interests of the special entity as required under paragraph (a)(1)(iii) of this section; and is subject to the requirements regarding political contributions, as applicable, under paragraph (a)(1)(vi) of this section;

and is legally obligated to comply with the requirements of Rule 15Fh-5(a)(1) by agreement, condition of employment, law, rule, regulation, or other enforceable duty.[1032]

Under Rule 15Fh-5(b)(2) as adopted, an SBS Entity shall be deemed to have a reasonable basis to believe that an ERISA special entity has a representative that satisfies the requirements of Rule 15Fh-5(a)(2), provided that the special entity provides in writing to the SBS Entity the representative's name and contact information, and represents in writing that the representative is a fiduciary as defined in Section 3 of ERISA. Obtaining the name and contact information provides the SBS Entity with basic information to investigate further if it becomes questionable whether it can reasonably rely on the special entity's representation or if the need arises for it to further investigate any of the representatives qualifications. In addition, it is highly likely that the SBS Entity will have the information in the ordinary course of negotiating the security-based swap if the independent representative is advising or negotiating the security-based swap on behalf of the special entity.

The Commission believes that the safe harbor will better enable an SBS Entity to fulfill its obligations under Rule 15Fh-5(a), while at the same time appropriately providing protections for special entities. The Commission also agrees with commenters that the safe harbor will increase the efficiency of SBS transactions, reduce costs, and mitigate counterparty confusion. We believe that although SBS Entities will need to obtain additional representations relating to meeting certain of the standards in Rule

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[1032] SBS Entities should keep in mind that reliance on these representation must be reasonable. As discussed in Section II.D, supra, reliance on a representation would not be reasonable if the SBS Entity has information that would cause a reasonable person to question the accuracy of the representation.

15Fh-5(a)(1), most SBS Entities and special entity representatives will still be able to leverage any existing compliance infrastructure established pursuant to the CFTC's safe harbor.[1033] Additionally, as discussed above, the bifurcated nature of the safe harbor appropriately recognizes existing ERISA regulations.[1034]

7. Disclosure of Capacity

a. Proposed Rule

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, and, if the SBS Dealer engages in business or has engaged in business within the last twelve months with the counterparty in more than one capacity, the SBS Dealer must disclose the material differences between such capacities in connection with the security-based swap and any other financial transaction or service involving the counterparty.[1035] Therefore, an SBS Dealer that is acting as a counterparty but not an advisor to a special entity 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).

1033 See Section VI.C.4.iv., infra. However, the CFTC safe harbor does not require the representative to represent that it has the knowledge required under paragraph (a)(1)(i) of this section; is not subject to a statutory disqualification under paragraph (a)(1)(ii) of this section; undertakes a duty to act in the best interests of the special entity as required under paragraph (a)(1)(iii) of this section; and is subject to the requirements regarding political contributions, as applicable, under paragraph (a)(1)(vi) of this section.

1034 See Section II.H.6.g., supra.

1035 See Section 15F(h)(5)(A)(2)(i) of the Exchange Act, 15 U.S.C. 78o-10(h)(5)(A)(2)(i).

As noted in the Proposing Release, a firm might act in multiple capacities in relation to a special entity. For example, the firm might act as an underwriter in a bond offering, as well as a counterparty to a security-based swap used to hedge the financing transaction.[1036] Because the SBS Dealer's duty to the special entity might vary according to the capacity in which it is acting, the special entity and its independent representative should understand the SBS Dealer's roles in any transaction.[1037] The proposed rule would therefore 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.[1038] The requirements of the proposed rule would apply 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" (emphasis added).

b. Comments on the Proposed Rule

The Commission received five comment letters on this proposed rule. Three commenters expressed concern over the burden imposed on large institutions, which would have to identify and disclose a myriad of possible relationships with special

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1036 See Swap Financial Group Presentation at 55.

1037 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). Similarly, Section 206(3) of the Investment Advisers Act of 1940 governs disclosure to a client when acting in certain capacities.

1038 See proposed Rule 15Fh-5(b).

entities.[1039] Conversely, one commenter suggested broadening the rule to apply to Major SBS Participants in addition to SBS Dealers.[1040] The last commenter suggested conforming the disclosure of capacity requirement to that of the CFTC.[1041]

The first commenter argued that the Commission's proposed capacity disclosure requirement was problematic for two reasons.[1042] First, it might conflict with some SBS Dealers' obligations to keep certain lines of business separated from one another. In this commenter's view, to comply with this requirement, large, multifaceted SBS Dealers that have different relationships with the same special entity could be forced to review activities throughout their entire organizations – in some cases, across informational walls that separate the different business lines of the firm. Second, the requirement might cause execution delays for special entities, since the SBS Dealer would need time to determine the disclosures it must make to the special entity. The commenter asked the Commission to clarify in the final rule that this disclosure requirement applied only to the SBS Dealer and the special entity, and that it would not apply to any associated persons of either the SBS Dealer or the special entity. The commenter additionally argued that the twelve-month look back period constituted a "moving target," and suggested that the Commission define the period as a calendar year, rather than a rolling twelve-month period.[1043]

1039 See SIFMA (August 2011), supra note 5; ABC, supra note 5; FIA/ISDA/SIFMA, supra note 5.

1040 See Better Markets (August 2011), supra note 5.

1041 See SIFMA (August 2015), supra note 5.

1042 See SIFMA (August 2011), supra note 5.

1043 Id.

Another commenter urged the Commission to allow SBS Entities to represent the capacity in which they were acting with respect to an ERISA plan in a schedule or amendment to an ISDA Master Agreement, other transactional document, or in an annual disclosure document provided by the SBS Entity to the special entity, which could be changed if the SBS Entity were to act in a different capacity.[1044] Because ERISA plans generally deal with SBS Entities as counterparties, the commenter believed this would be an effective and non-burdensome way to make such representations. The commenter additionally asserted that it might be harmful to a special entity to require an SBS Entity to disclose the myriad different capacities in which the SBS Entity has acted with respect to the special entity – since requiring SBS Dealers with diverse global operations to disclose every relationship with a plan (which often has multiple investment managers and service providers), then requiring the plan manager to review such disclosures would pose a significant administrative burden and result in high costs and delayed trades. These costs would likely be passed on to special entities.

Another commenter argued that it "would be impossible for an SBS Entity to ascertain and disclose every other relationship it may have with its counterparties" because large financial institutions have multiple points of contact with counterparties, making it impossible to systematically collect and disclose the required information.[1045] This commenter argued that the Proposing Release did not include an analysis of the costs associated with the requirement to disclose capacity. The commenter recommended

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1044 See ABC, supra note 5. Some commenters referenced both SBS Dealers and Major SBS Participants although the Commission only proposed to apply the requirement to SBS Dealers.

1045 See FIA/ISDA/SIFMA, supra note 5.

that the Commission narrow this requirement to cover only disclosure of the material differences between the capacities in which the SBS Entity itself (and not any of its affiliates or other associated persons) acted in connection with the relevant security-based swap transaction. In the alternative, the commenter suggested that the Commission require disclosure regarding the capacities in which the SBS Entity has acted with respect to the counterparty other than in connection with the relevant security-based swap transaction, and that the SBS Entity should be permitted to satisfy that requirement with a generic disclosure of the general types of capacities in which it may act or have acted with respect to the counterparty (along with a statement distinguishing those capacities from the capacity in which the SBS Entity is acting with respect to the present security-based swap).

One commenter suggested that the capacity disclosure requirement be applied equally to SBS Dealers and Major SBS Participants, as it would maximize the protection for special entities.[1046]

After the adoption of the CFTC's final rules, a commenter subsequently recommended deleting this twelve-month "look back" period, as well as the requirement that SBS Dealers disclose the material differences between such capacities "in connection with the security-based swap and any other financial transaction or service involving the counterparty."[1047] According to the commenter, these modifications would harmonize

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1046 See Better Markets (August 2011), supra note 5.

1047 See SIFMA (August 2015), supra note 5.

the Commission's rule with the parallel CFTC rule, and reduce confusion among counterparties regarding the nature of their relationship with an SBS Dealer.[1048]

c. Response to Comments and Final Rule

Upon consideration of the foregoing comments, the Commission is adopting proposed Rule 15Fh-5(b), renumbered as Rule 15Fh-5(c), with several modifications in response to comments. 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, and, if the SBS Dealer engages in business or has engaged in business within the last twelve months with the counterparty in more than one capacity, the SBS Dealer must disclose the material differences between such capacities in connection with the security-based swap and any other financial transaction or service involving the counterparty. As discussed below, in response to comments, the Commission is amending the first part of the rule to clarify that the disclosure of the capacity in which the SBS Dealer is acting is "in connection with the security-based swap." The Commission also is amending the second part of the rule to clarify the capacities between which material differences must be disclosed. In addition, we are deleting the 12 month look-back period. Specifically, under the rule, as adopted (renumbered as Rule 15Fh-5(c)), before initiation of a security-based swap, an SBS Dealer must disclose to the special entity in writing the capacity in which the SBS Dealer is acting "in connection with the security-based swap," and, if the SBS Dealer engages in

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[1048] Id.

business[1049] with the counterparty in more than one capacity, the SBS Dealer must disclose the material differences between the capacity in which the SBS Dealer is acting with respect to the security-based swap and the capacities in which it is acting with respect to any other financial transaction or service involving the counterparty to the special entity.

Several commenters argued that the proposed requirement that the SBS Dealer disclose the capacity in which it was acting was too broad and would require the disclosure of a myriad of possible relationships.[1050] Some commenters suggested that the relevant disclosure should be the capacity in which the SBS Dealer is acting "in connection with the security-based swap" and suggested the rule should be narrowed accordingly.[1051] A commenter also suggested that the Commission revise the disclosure of different capacities to eliminate the language that requires such disclosures to be "in connection with the security-based swap and any other financial transaction or service involving the counterparty."[1052]

The Commission agrees with commenters that the disclosure of capacity in the first part of the rule should be limited to the capacity in which the SBS Dealer is acting in connection with the security-based swap, and has amended the rule to clarify this

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1049 As discussed below, the rule is designed to help ensure that the special entity understands the SBS Dealer's role in the security-based swap transaction that is being initiated, and to distinguish that role, if applicable, from its role with respect to any other services the SBS Dealer is providing or transactions in which it is involved with the special entity. The term "engages in" should be interpreted broadly to achieve that goal.

1050 SIFMA (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5; and ABC, supra note 5.

1051 See ABC, supra note 5; SIFMA (August 2011), supra note 5.

1052 See SIFMA (August 2015), supra note 5.

limitation. However, the Commission declines the commenter's suggestion to eliminate the disclosure of material differences between or among the different capacities in which the SBS Dealer is acting "in connection with the security-based swap and any other financial transaction or service involving the counterparty."[1053] The proposed rule was designed to provide the counterparty with sufficient information about the capacity in which the SBS Dealer is acting, and any material differences between its capacity in connection with the security-based swap and any other financial transaction or service involving the counterparty, to help ensure that the counterparty understands the SBS Dealer's role in the security-based swap transaction that is being initiated, and to distinguish that role, if applicable, from its role with respect to any other services it is providing or transactions in which it is involved with the counterparty. Eliminating the requirement that the SBS Dealer disclose the material differences in the different capacities in which it is acting would not address potential counterparty confusion that could arise when a SBS Dealer changes status from transaction to transaction.

Some commenters expressed concerns regarding the burden and practical issues relating to having to apply this disclosure requirement to the activities of associated persons of the SBS Dealer[1054] and associated persons of the special entity.[1055] The Commission recognizes the practical and operational difficulties described in the comment letters in determining the capacity in which associated persons, including affiliates, are acting or have acted with respect to the special entity. The Commission

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1053 See FIA/ISDA/SIFMA, supra note 5; and SIFMA (August 2015), supra note 5.

1054 See SIFMA (August 2011), supra note 5.

1055 See FIA/ISDA/SIFMA, supra note 5.

also recognizes the role of the independent representative in advising the special entity with respect to these transactions. Given these considerations, the Commission agrees with the commenter it would be appropriate for the SBS Dealer to use generalized disclosures regarding the other capacities in which the SBS Dealer and its associated persons, including affiliates, have acted or may act with respect to the special entity and its associated persons, along with a statement distinguishing those capacities from the capacity in which the SBS Dealer is acting with respect to the present security-based swap.[1056] Such disclosure would require consideration of the SBS Dealer's business and the types of capacities in which it and its associated persons has acted or may act with respect to the particular special entity. We believe that this generalized disclosure of other capacities will help ensure that the counterparty understands the SBS Dealer's role in the security-based swap transaction that is being initiated, and to distinguish that role, if applicable, from its role with respect to any other services it is providing or transactions in which it is involved with the counterparty.

After consideration of the comments, the Commission also acknowledges the commenters' concerns regarding the workability and potential delay in execution of transactions and increased costs the twelve month look back may cause. Accordingly, the Commission has also modified the adopted rule to eliminate the 12-month look back period for business in which the SBS Dealer has engaged.

As discussed in Section II.G.2.b. above, the Commission does not prescribe the manner in which these disclosure must be made. In response to comments received,[1057]

1056 Id.

1057 See ABC, supra note 5.

the Commission notes that the required disclosures could be made in a transactional document or an annual disclosure document, depending on the number of capacities in which the SBS Dealer is acting and whether such capacities have changed. In any event, the disclosure must be sufficient to meet the requirements of the rule, which is designed to ensure that the special entity understands the SBS Dealer's role in the security-based swap transaction that is being initiated, and to distinguish that role, if applicable, from its role with respect to any other services the SBS Dealer is providing or transactions in which it is involved with the special entity.

Finally, the Commission declines to apply Rule 15Fh-5(c) to Major SBS Participants, since the statutory requirement, by its terms, requires disclosure in writing of "the capacity in which the security-based swap dealer is acting." Furthermore, as discussed in Section II.C., supra, we have not sought to impose the full range of business conduct requirements on these Major SBS Participants. We note that our approach in this regard largely mirrors that of the CFTC, under whose rules Swap Entities have operated for some time.

8. Exceptions for Anonymous, Special Entity Transactions on An Exchange or SEF

a. Proposed Rules

As previously discussed in Section II.B, supra, Section 15F(h)(7) of the Exchange Act provides that "[t]his subsection shall not apply with respect to a transaction that is (A) initiated by a special entity on an exchange or security-based swap execution facility; and (B) one in which the security-based swap dealer or major security-based swap

participant does not know the identity of the counterparty to the transaction."[1058] We proposed 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.[1059] We further proposed exceptions from the requirement of proposed Rules 15Fh-4 (special requirements for SBS Dealers acting as advisors to special entities) and 15Fh-5 (special requirements for SBS Entities acting as counterparties to special entities) for such transactions.

b. Comments on the Proposed Rules

The Commission received five comments that generally addressed the exception for anonymous or SEF and exchange-traded security-based swaps ,[1060] and five comments that specifically addressed the exception for anonymous, exchange or SEF-traded security-based swaps with special entities.[1061] The comment letters that generally address this exception are discussed above, in Section II.B, supra.

In the specific context of security-based swap transactions with special entities, one commenter suggested that the business conduct standards should only apply to non-SEF and non-exchange traded transactions, regardless whether the transaction is anonymous.[1062] This commenter urged the Commission to clarify that the proposed rules

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1058 15 U.S.C. 78o-10(h)(7).

1059 See Proposing Release, 76 FR at 42421, supra note 3.

1060 See CFA, supra note 5; SIFMA (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5; MFA, supra note 5; BlackRock, supra note 5.

1061 See ABC, supra note 5; SIFMA (August 2015), supra note 5; CFA, supra note 5; Better Markets (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5.

1062 See ABC, supra note 5.

would not apply to any security-based swap transaction that is entered into by a special entity on a designated contract market or SEF.[1063]

Two commenters addressed the Commission's proposal to apply the statutory exception to any anonymous transaction with a special entity on a registered exchange or SEF.[1064] One commenter supported this proposal as a "reasonable approach which is consistent with Congressional intent that the enhanced protections apply to transactions where there is a degree of reliance by the special entity on the dealer or major swap participant."[1065] The second commenter argued that the exception in Section 15Fh(7) was intended to apply to all external business conduct requirements promulgated under subsection (h), and not merely those requirements relating to SBS Dealers acting as advisors or counterparties to special entities.[1066]

Another commenter argued that Congress did not intend for the exception to apply when SBS Entities initiate transactions on a SEF or an exchange.[1067] According to this commenter, SBS Entities seeking to conduct business on a SEF or exchange should bear the risk that their counterparties are special entities, as the risk would incentivize SBS Entities to determine the identity of their counterparties when they initiate security-based swap transactions on an SEF or exchange. The commenter recommended that the Commission adopt a "clear test" for determining when a special entity "initiates" a security-based swap transaction, and that the test differentiate between initiating a

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1063 Id.

1064 See CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5.

1065 See CFA, supra note 5.

1066 See FIA/ISDA/SIFMA, supra note 5.

1067 See Better Markets (Aug. 2011), supra note 5.

negotiation and initiating a transaction.[1068] After adoption of the CFTC's business conduct standards, another commenter urged the Commission to adopt an exception for exchange-traded security-based swaps that are intended to be cleared if: (1) the transaction is executed on a registered or exempt security-based swap execution facility or registered national security exchange; and (2) is of a type that is, as of the date of execution, required to be cleared pursuant to Section 3C of the Exchange Act; or (3) the SBS Dealer does not know the identity of the counterparty, at any time up to and including execution of the transaction.[1069] The commenter argued that these modifications would harmonize the scope of the SEC's special entity requirements with the parallel CFTC requirements set forth under the relief provided by CFTC No-Action Letter 13-70.[1070]

c. Response to Comments and Final Rules

After consideration of the comments, the Commission is adopting Rule 15Fh-4(b)(3) and Rule 15Fh-5(c) (the latter renumbered as 15Fh-5(d)) with several modifications. Under the rules as adopted, the business conduct requirements of Rules 15Fh-4 and 15Fh-5 will not apply to a security-based swap with a special entity if: (1) the transaction is executed on a registered SEF, exempt SEF, or registered national securities exchange; and (2) the SBS Dealer and/or Major SBS Participant does not know the identity of the counterparty at a reasonably sufficient time prior to the execution of the transaction to permit the SBS Dealer and/or Major SBS Participant to comply with the

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1068 Id.

1069 See SIFMA (August 2015), supra note 5.

1070 Id.

obligations of the rule.[1071] The language of these exceptions, as adopted, differs from the language of the proposed rules, which would have applied the exceptions where the SBS Dealer or Major SBS Participant did not know the identity of its counterparty "at any time up to and including" execution of the transaction, and only to transactions executed on a registered SEF or national exchange.

As discussed in Section II.B, by limiting the scope of the business conduct standards to situations where the counterparty's identity is known at a reasonably sufficient time prior to the execution of a transaction to permit the SBS Dealer and/or Major SBS Participant to comply with the obligations of the rule, the Commission seeks to relieve SBS Dealers and/or Major SBS Participants of the duty to comply with the rules' requirements where the counterparty's identity is learned immediately prior to the execution of a transaction, so that the SBS Entity would be able to comply with the requirements of the rules in a manner that would not be disruptive to the counterparties to the transaction. This change is intended to address commenters' concerns that compliance with the rules might be unreasonable or impractical where a counterparty's identity is learned immediately prior to the transaction, and compliance could result in the delay or disruption of the transaction.[1072] Such delay or disruption would negate a primary advantage of electronic trading and discourage market participants from executing security-based swaps on electronic platforms. By only applying the rules' requirements to situations where the counterparty's identity is known "at a reasonably

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[1071] As noted above, Rule 15Fh-4 applies only to SBS Dealers, whereas Rule 15Fh-5 applies to both SBS Dealers and Major SBS Participants. See Sections II.H.2 and II.H.5.a.iii.A, respectively, supra.

[1072] See CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5.

sufficient time prior to" the execution of a transaction, the rules' requirements are limited to situations where an SBS Entity has sufficient time before the execution of the transaction to comply with its obligations under the rules. For this reason, we decline to adopt language, suggested by a commenter, which would apply the exception to circumstances where the identity of the counterparty "is not known at any time up to and including execution of the transaction."[1073] For clarification, and in response to commenters,[1074] the exception would encompass transactions that are executed by an SBS Entity on a registered or exempt SEF or registered national securities exchange via a request for quote method, as long as the identity of the counterparty is not known to the SBS Entity at a reasonably sufficient time prior to the execution of a transaction to permit the SBS Entity to comply with the obligations of the rules.[1075]

Also, as explained in Section II.B, the exception would apply with respect to transactions on exempt as well as registered SEFs. We believe that including transactions on exempt SEFs is appropriate since, as discussed in Section II.B, the practical considerations that underlie the exception are not affected by whether a SEF is registered or not.

We believe that the exceptions under Rule 15Fh-4(b)(3) and 15Fh-5(d), as adopted, appropriately interpret the intended statutory carve-outs for SBS Entities

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1073 See SIFMA (August 2015), supra note 5.

1074 See FIA/ISDA/SIFMA, supra note 5; MFA, supra note 5.

1075 The rule will apply to situations where an SBS Entity negotiates or pre-arranges a security-based swap transaction with a special entity and routes such a pre-arranged transaction through a SEF or registered national securities exchange. In such instances, we believe the SBS Entity would have known the identity of the counterparty at a reasonably sufficient time prior to the execution of the transaction to permit the SBS Entity to comply with the obligations of the rule.

engaged in anonymous, registered exchange-traded, registered or exempt SEF transactions with special entities, while avoiding the ambiguity inherent in determining which party "initiated" the security-based swap. The final rule therefore obviates the need to differentiate between initiating a negotiation and initiating a transaction, as one commenter had requested.[1076]

We acknowledge the commenter's suggestion that the exception should apply irrespective of which party initiates a transaction,[1077] as well as another commenter's suggestion that Congress may have intended to deny the exception in situations in which an SBS Entity initiates a transaction, so that SBS Entities would be incentivized to determine the identities of their counterparties when they initiate security-based swap transactions.[1078] As explained in Section II.B, we understand there may be practical difficulties in determining which counterparty "initiates" a transaction on a SEF or an exchange. However, we believe the rules adopted today avoid the ambiguity inherent in determining which party "initiated" the security-based swap, while appropriately interpreting the intended statutory carve-outs for SBS Entities that execute anonymous, security-based swap transactions with special entities on a registered or exempt SEF or registered national securities exchange.

We are not accepting the commenter's suggestion that we revise the exceptions under 15Fh-4(b)(3) and 15Fh-5(d) to include transactions that are intended or required to be cleared, which are either executed on a registered national securities exchange or SEF,

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1076 See Better Markets (August 2011), supra note 5.

1077 See CFA, supra, note 5.

1078 See Better Markets (August 2011), supra note 5.

regardless of whether the transaction is anonymous.[1079] Similarly, we reject commenters' more general assertion that the exceptions should apply to all SEF or exchange traded transactions, even where the identity of the counterparty is known.[1080] Rather, we agree with the commenter that it is appropriate to apply the protections of the business conduct rules to all security-based swap transactions with special entities other than anonymous transactions executed on a registered national securities exchange or SEF.[1081] The rules adopted today are intended to provide certain protections for special entities, and we think it is appropriate to apply the rules, to the extent practicable, so that special entities receive the benefits of those protections. Where the identity of the special entity is known, we believe that it is appropriate to apply the rules so that the special entity receives the benefits of the protections provided by the rules, including the assistance of an advisor or qualified independent representative acting in the best interests of that special entity.

Lastly, we acknowledge the improbability that an SBS Dealer who is acting as an advisor to a special entity and is therefore subject to the requirements of Rule 15Fh-4 would not know the identity of its special entity counterparty. Consequently, we also acknowledge that the circumstances where the exception under Rule 15Fh-4(b)(3) would apply are unlikely, and, in any event, we would question the appropriateness of an SBS Dealer making a recommendation to an unknown special entity. Nevertheless, we believe there is value is providing legal certainty for SBS Dealers that seek to transact on

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1079 See SIFMA (August 2015), supra note 5.

1080 See ABC, supra note 5; FIA/ISDA/SIFMA, supra note 5.

1081 See CFA, supra note 5.

a registered national securities exchange or a registered or exempt SEF without regard to the regulatory status of their counterparty.

9. Certain Political Contributions by SBS Dealers

a. Proposed Rule

As proposed, Rule 15Fh-6(b)(1) would generally make it unlawful for an SBS 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" has been made by the SBS Dealer or any of its "covered associate[s]." Proposed Rule 15Fh-6(b)(3)(i) would also prohibit an SBS Dealer from paying a third party to "solicit" municipal entities to offer to enter into, or enter into, a security-based swap, unless the third party is a "regulated person" that is itself subject to a pay to play restriction under applicable law. Proposed Rule 15Fh-6(b)(3)(ii) would prohibit an SBS Dealer from coordinating or soliciting a third party, including a political action committee, to make any: (a) contribution to an official of a municipal entity with which the SBS Dealer is offering to enter into, or has entered into, a security-based swap, or (b) payment to a political party of a state or locality with which the SBS Dealer is offering to enter into, or has entered into, a security-based swap. Finally, 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.

As proposed, Rule 15Fh-6(b) included three main exceptions. First, proposed Rule 15Fh-6(b)(2)(i) 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, to any one official for whom the individual was entitled to vote at the

time of the contributions, and up to $150 per election, to any one official for whom the individual was not entitled to vote at the time of the contributions.[1082] Second, proposed Rule 15Fh-6(b)(2)(ii) would not apply the proposed pay to play rules to contributions made by an individual 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. Third, proposed Rule 15Fh-6(b)(2)(iii) would not apply the proposed pay to play rules 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.

In addition to the above exceptions, proposed Rule 15Fh-6(e)(1) would provide an automatic exception to allow an SBS Dealer a limited ability to cure the consequences of an inadvertent political contribution where: (i) the SBS Dealer discovered the contribution within four months (120 calendar days) of the date of the contribution; (ii) the contribution made did not exceed $350; and (ii) the contribution was returned to the contributor within 60 calendar days of the date of discovery. However, 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.

Furthermore, under proposed Rule 15Fh-6(d) an SBS Dealer may apply to the

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[1082] As discussed below, we are modifying the text of this rule to clarify that the de minimis contribution exception is limited to contributions made by individuals so that the rule text tracks the explanation of the exception that was outlined in the Proposing Release and in the CFTC's Adopting Release for its analogous exception, as well as the text of the Advisers Act Rule, upon which the exception is modeled and is intended to complement.

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 in 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 was made, 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.

b. Comments on the Proposed Rule

Six commenters addressed proposed Rule 15Fh-6.[1083] One commenter, who supported the proposal as applied to SBS Dealers, stated that pay-to-play is an appropriate area for the Commission to exercise its authority and suggested that this proposal "would help to eliminate what would otherwise be a serious gap in

[1083] See APPA, supra note 5; CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; NAIPFA, supra note 5; SIFMA (August 2011), supra note 5; SIFMA (August 2015), supra note 5.

protections."[1084] However, this same commenter does not believe the Commission should exempt Major SBS Participants from the proposed pay-to-play rules based on what this commenter claims "may turn out to be a false 'assumption' that they will not be engaged in the type of activity that would make them appropriate."[1085]

Another commenter agreed that the prohibition timeframe should be two years, consistent with proposed Rule 15Fh-6(b)(1).[1086] That same commenter also believed that there are no circumstances where 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 rules.[1087]

One commenter recommended that, with respect to the proposal that independent representatives be subject to "pay to play" limitations, an exception is needed "for advisors that are employees of the special entity, given the employer-employee relationship."[1088] That same commenter also urged the Commission to delay imposing the proposed pay to play rule until after the "dealer" definitions are finalized.[1089]

1084 CFA, supra note 5.

1085 CFA, supra note 5.

1086 See NAIPFA, supra note 5.

1087 See NAIPFA, supra note 5.

1088 APPA, supra note 5.

1089 APPA, supra note 5 (stating in support of that suggestion that "[w]hile financial institutions that deal with municipal entities are more likely to have compliance procedures in place to deal with pay-to-play rules, other entities that may ultimately be considered SBS Dealers are much less likely to have such systems in place or to be familiar with these types of rules").

Another commenter suggested, as a general matter, that because the Dodd-Frank Act did not mandate any restrictions on political contributions by SBS Dealers it is not clear to that commenter that the Commission needs to impose such a requirement on a discretionary basis.[1090] This same commenter, however, recommended that the Commission revise the language of the proposed rule to, at least in the commenter's view, parallel the following aspects of MSRB's regulations: (1) replace as the triggering occasion for the application of the proposed rule an "offer to enter into or enter into a security-based swap or a trading strategy involving a security-based swap" with a term—"engage in municipal security-based swap business"—which they suggest is "more akin to the terms used in the relevant MSRB Rules"; (2) define "municipal security-based swap business" in the proposed rule to mean "the execution of a security-based swap with a municipal entity"; (3) narrow the definition of "solicit" in the proposed rule to include only "any direct communication by any person with a municipal entity for the purpose of obtaining or retaining municipal security-based swap business," so that the term "solicit" does not "implicate communication by employees of a financial institution that do not have a role in the security-based swap business and who are already regulated by the MSRB or the SEC"; (4) clarify the definition of "solicit" in the proposed rule to "exclude[s] any communication by any person with a municipal entity for the sole purpose of obtaining or retaining any other type of business covered under pay to play

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1090 See FIA/ISDA/SIFMA, supra note 5 (stating that MSRB rules "on political contributions made in connection with municipal securities business will already cover most [SBS Dealers] doing business with municipal entities, and, there may not be much marginal benefit to imposing additional restrictions on SBSDs generally"). See also id. ("Because the Commission's proposal is nearly identical to the CFTC Proposal, our comments generally track those we made in response to the CFTC Proposal.").

restrictions, such as municipal securities business or municipal advisory business"; and (5) modify the proposed rule to allow for up to three exemptions for inadvertent contributions, depending on the number of SBS Dealer employees.[1091] The same commenter also recommended that the Commission include a provision specifying "an operative date of the rule such that it only applies to contributions made on or after its effective date."[1092]

Finally, one commenter suggested that the Commission create a safe harbor from the pay to play rule for a special entity that is represented by a qualified independent representative that affirmatively selects the SBS Dealer. [1093] That commenter also suggests excluding state-established plans that are managed by a third-party, such as 529 college savings plans, from the pay to play provisions because otherwise, the provisions would deter SBS Dealers from transacting with the plans.

After the adoption of the CFTC's rules in 2015, this same commenter subsequently proposed that the Commission expressly except from the prohibitions of Rule 15Fh-6(b)(1) contributions that were "made before the security-based swap dealer registered with the Commission as such."[1094] According to the commenter, these changes would be consistent with CFTC No-Action relief, which clarified that the "look back" period would not include any time period before an SBS Dealer is required to register as such, and would therefore prevent retroactive application of the rule.[1095] The commenter

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1091 FIA/ISDA/SIFMA, supra note 5.

1092 FIA/ISDA/SIFMA, supra note 5.

1093 See SIFMA (August 2011), supra note 5.

1094 See SIFMA (August 2015), supra note 5.

1095 Id.

further suggested that the Commission modify the exception under 15Fh-6(b)(2)(B)(iii), such that it would apply to a security-based swap that was "executed" by a municipal entity on a registered national securities exchange or registered or an "exempt" security-based swap execution facility, and was of a "type that is, as of the date of execution, required to be cleared pursuant to Section 3C of the Act."[1096] In the alternative, the commenter suggested that the exception should apply where the SBS Dealer does not know the identity of the counterparty to the transaction at any time up to and including execution of the transaction.[1097]

c. Response to Comments and Final Rule

After considering the comments, the Commission is adopting Rule 15Fh-6 with six modifications. First, after the Proposing Release was published, an inadvertent omission was identified in the definition of "contribution" in proposed Rule 15Fh-6(a)(1)(i). The Proposing Release inadvertently omitted the word "federal" in subsection (i) of the proposed definition of "contribution" in Rule 15Fh-6(a)(1). Although the Commission did not receive any comments noting this omission, we are modifying the rule text to include the word "federal" in subsection (i) of the final definition of "contribution" in Rule 15Fh-6(a)(1)).[1098] Furthermore, and as stated in the Proposing Release, the Commission explained that "Rule 15Fh-6 is modeled on, and intended to

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1096 Id.

1097 Id.

1098 As such, Final Rule 15Fh-6(a)(1)(i) will read "[f]or the purpose of influencing any election for federal, state or local office." In light of this modification, and for purposes of internal consistency with a parenthetical reference to this rule text elsewhere in the rule, a parallel modification is being made to Final Rule 15Fh-6(d)(5), which will read: "The nature of the election (e.g., federal, state or local)."

complement, existing restrictions on pay to play practices under Advisers Act Rule 206(4)-5 . . . and under MSRB Rules G-37 and G-38."[1099] Importantly, both Advisers Act Rule 206(4)-5(f)(1)(i) and MSRB Rule G-37(g)(i)(A)(1) include the word "federal" in their largely identical definitions of the term "contribution." The Commission is correcting this inadvertent omission to make the definition of "contribution" in Rule 15Fh-6(a)(1)(i) consistent with the Commission's existing definition of "contribution" under Advisers Act Rule 206(4)-5(f)(1)(i).[1100] Correcting this omission also will make the definition of "contribution" in Rule 15Fh-6(a)(1) consistent with the existing definition of "contribution" under CFTC Regulation 23.451(a)(1)(i) and, therefore, create a harmonized regulatory framework that complements and is comparable to Advisers Act Rule 206(4)–5, MSRB Rules G–37 and CFTC Regulation 23.451.[1101] Based on the foregoing, the Commission believes that correcting this inadvertent omission in a rule that was, as set forth in the Proposing Release, "modeled on, and intended to

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1099 Proposing Release, 76 FR at 42433, supra note 3.

1100 See Political Contributions by Certain Investment Advisers, Advisers Act Release No. 3043 (Jul. 1, 2010), 75 FR 41018 (Jul.14, 2010) ("Advisers Act Pay-to-Play Release") (adopting Advisers Act Rule 206(4)-5 and stating, among other things, that the definition of "contribution" in Advisers Act Rule 206(4)-5 "is the same as . . . the one used in MSRB rule G-37").

1101 Although subsection (iii) of CFTC Regulation 23.451(a)(1) also includes the term "federal" in the definition of "contribution"—"[f]or transition or inaugural expenses incurred by the successful candidate for federal, state, or local office."—as explained by the Commission in the Advisers Act Pay-to-Play Release, neither Rule 206(4)-5 nor MSRB Rule G-37 includes the transition or inaugural expenses of a successful candidate for *federal* office in the definition of "contribution." See Advisers Act Pay-to-Play Release, 75 FR at 41030, n.154, supra note 1100. Therefore, because this rule is modeled on, and intended to complement, existing restrictions on pay to play practices under Advisers Act Rule 206(4)-5 and MSRB Rules G-37, we also do not include the term "federal" in subsection (iii) of Rule 15Fh-6(a)(1) for the same reasons stated by the Commission when adopting the Advisers Act pay-to-play rules.

complement, existing restrictions on pay to play practices"[1102] will eliminate an unintentional gap in pay to play protections across regulatory regimes that would otherwise be created. In light of cross-market participation and expected dual registration of some entities, substantial consistency across pay to play regulatory regimes, including having largely consistent definitions of "contribution," will also be helpful for those entities that have already established a regulatory infrastructure to comply with pay to play standards under existing rules.

Second, the Commission is correcting another inadvertent omission in the text of Rule 15Fh-6(b)(2)(i). As outlined in the Proposing Release, the de minimis contribution exception found in Rule 15Fh-6(b)(2)(i) is intended to be limited to contributions made by individuals that are covered associates to track and complement the similar de minimis contribution exception found in Advisers Act Rule 206(4)-5(b)(1), upon which this exception was modeled.[1103] Because this exception is conditioned on whether the covered associate was entitled to vote for the official at the time of the contribution, we believe it was implicit in the proposed rule text that this exception only applies to contributions made by a natural person since other legal persons are not entitled to vote. However, we are modifying the text of Rule 15Fh-6(b)(2)(i) to clarify that this exception only applies to contributions made by a natural person. With that modification, the rule text as adopted will track the explanation behind this exception, as explained in the

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1102 Proposing Release, 76 FR at 42433, supra note 3.

1103 See Proposing Release, 76 FR at 42434, supra note 3 ("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.") (emphases added).

Proposing Release, as well as the text of Advisers Act Rule 206(4)-5(b)(1). This modification will also make Rule 15Fh-6(b)(2)(i) consistent with the CFTC's analogous de minimis contribution exception, which the CFTC described as similarly intended to be limited to individuals that are covered associates.[1104]

Third, as discussed in Section II.B, the Commission is modifying the exception under Rule 15Fh-6(b)(2)(iii) so as to apply when the SBS Dealer does not know the identity of the counterparty with reasonably sufficient time prior to execution of the transaction to permit the SBS Dealer to comply with the obligations of the rule. This language differs from the language used in the proposal, which would apply the exception when the dealer does not know the identity of the counterparty "at any time up to and including execution of the transaction." The adoption of this language will comport with the language used in the verification of counterparty status and disclosure requirements of final Rule 15Fh-3, as well as the exceptions to the special entity requirements under Rules 15Fh-4(b)(3) and 15Fh-5(d). As discussed in those sections, this language is intended to exclude situations where the identity of the counterparty is not discovered until after execution of a transaction, or where the SBS Dealer learns the identity of the counterparty with insufficient time to be able to satisfy its obligations under the rule without delaying the execution of the transaction.

[1104] See CFTC Adopting Release, 77 FR at 9799, supra note 21 (explaining that CFTC's "proposed rule permitted an individual that is a covered associate to make aggregate contributions up to $350 per election, without being subject to the two-year time out period, to 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.") (emphases added).

Fourth, as discussed above in Section II.H.8, the Commission is also modifying the exception under Rule 15Fh-6(b)(2)(iii) to apply to all security-based swap transactions executed on a registered or exempt SEF or registered national securities exchange , rather than just with respect to transactions "initiated by a municipal entity" on such exchange or SEF (as long as the other conditions of Rule 15Fh-6(b)(2)(iii) are met). We are revising the rule to be consistent with the adopted Rules 15Fh-4(b)(3) and 15Fh-5(d), and avoid the ambiguity inherent in determining which party "initiated" the security-based swap.[1105]

Fifth, we are also modifying Rule 15Fh-6(e)(2), as one commenter suggested,[1106] to allow for up to three exemptions for inadvertent contributions per calendar year, depending on the number of natural person covered associates at the SBS Dealer. Specifically, we are modifying the text of Rule 15Fh-6(e)(2), as suggested by this same commenter,[1107] to provide that an SBS Dealers that has more than 50 covered associates would be able to rely on this exception no more than three times per calendar year, while an SBS Dealer that has 50 or fewer covered associates would be able to rely on this exception no more than two times per calendar year. This modification will parallel the provision in Advisers Act Rule 206(4)-5, which also allows "larger" investment advisers to avail themselves of three automatic exceptions, instead of two, in any calendar year.

1105 See supra Section II.H.8.

1106 FIA/ISDA/SIFMA, supra note 5 (suggesting that the Commission modify proposed rule to allow for up to three exemptions for inadvertent contributions, depending on the number of SBS Dealer employees).

1107 See id. (suggesting that the Commission modify proposed rule to parallel the provisions in SEC Rule 206(4)-5, relating to contributions from certain covered associates of investment advisers).

As the Commission noted when modifying its Advisers Act rule proposal to include three automatic exceptions for larger firms, we agree that inadvertent violations of the rule are more likely at firms with greater numbers of covered associates, and we believe that the twice per year limit is appropriate for smaller firms and that the three times per year limit is appropriate for larger firms.[1108] Although we recognize that this modification will create an additional exception not found in the CFTC's analogous rule,[1109] we believe that harmonization across the Commission's regulatory regimes will help to create regulatory efficiencies for entities that have already established a regulatory infrastructure based on the Commission's analogous exception.

Finally, the Commission is also correcting in the final rule the following typographical errors: (1) revising an internal cross-reference in Rule 15Fh-6(a)(2)(iii) to cross-reference "paragraphs (a)(2)(i) and (a)(2)(ii) of this section" rather than "paragraphs (c)(2)(i) and (c)(2)(ii) of this section"; (2) revising an internal cross-reference in Rule 15Fh-6(d) to cross-reference "paragraph (b) of this section" rather than "paragraph (a)(1) of this section"; (3) revising Rule 15Fh-6(b)(3)(ii)(A) to delete a phrase that was inadvertently repeated "a security-based swap security-based swap"; and (4) revising Rule 15Fh-6(b)(3)(ii)(B) to also delete a phrase that was inadvertently repeated "a security-based swap security-based swap."

1108 See Advisers Act Pay-to-Play Release, 75 FR at 41035-36, n. 238, supra note 1100 ("We do not believe it is appropriate for there to be greater variation in the number of times advisers may rely on the exception than that based either on their size or on other characteristics. We are seeking to encourage robust monitoring and compliance.").

1109 See CFTC Adopting Release, 77 FR at 9828, supra note 21.

With respect to the balance of Rule 15Fh-6, after considering the comments submitted, the Commission is adopting the Rule as proposed. The Commission disagrees with certain commenters' view that Rule 15Fh-6 is not an appropriate area for the Commission to exercise its authority to prescribe business conduct standards.[1110] The Commission also disagrees with one commenter's suggestion that there may not be much marginal benefit to imposing additional restrictions on SBS Dealers generally.[1111] We proposed the rule in the context of security-based swaps because 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.[1112] We note that SBS Dealers

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1110 See, e.g., FIA/ISDA/SIFMA, supra note 5 (suggesting that because Dodd-Frank did not mandate any restrictions on political contributions by SBS Dealers it is not clear that the Commission needs to impose such a requirement on a discretionary basis). But see CFA, supra note 5.

1111 See FIA/ISDA/SIFMA, supra note 5.

1112 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) (settled order instituting administrative and cease-and-desist proceedings and imposing remedial sanctions against a broker-dealer that the Commission alleged was awarded bond underwriting and interest rate swap agreement business by

may have an incentive to participate in pay to play practices out of concern that they may be overlooked if they fail to make such contributions. These concerns, coupled with the furtive nature of pay to play practices and the inability of markets to properly address them, strongly support the need for prophylactic measures to address them in the context of security-based swaps.[1113] Furthermore, and as the same commenter concedes, there would still be a regulatory gap as only "most" SBS Dealers would be covered and, as another commenter observed, this rule would help to eliminate that gap in protection.[1114] We made this same point in the Proposing Release, noting that while Rule 15Fh-6 is consistent with and would complement the pay to play prohibition adopted by the MRSB and CFTC, there are no existing federal pay to play rules that would apply to *all* SBS Dealers in their dealings with municipal entities.[1115] Therefore, this rule was proposed to help eliminate that regulatory gap.

The Commission continues to believe and a commenter also agrees that the two-year time out provided for in Rule 15Fh-6 is appropriate.[1116] As explained in the Proposing Release, Rule 15Fh-6(b)(1) would prohibit an SBS Dealer from offering to enter into, or entering into, a security-based swap or a trading strategy involving a

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Jefferson County in connection with undisclosed payments by employees of the firm).

1113 Cf. Blount v. SEC, 61 F.3d 938, 945 (D.C. Cir. 1995), cert. denied, 116 S. Ct. 1351 (1996) ("no smoking gun is needed where, as here, the conflict of interest is apparent, the likelihood of stealth great, and the legislative purpose prophylactic").

1114 CFA, supra note 5 (supporting the proposal as applied to SBS Dealers and stating that this proposal "would help to eliminate what would otherwise be a serious gap in protections").

1115 Proposing Release, 76 FR at 42433, supra note 3.

1116 See NAIPFA, supra note 5.

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 generally consistent with the time out provisions in Advisers Act Rule 206(4)-5, MSRB Rule G-37 and CFTC Regulation 23.451.

As we also explained in the Proposing Release, because the rule would attribute to an SBS Dealer those contributions made by a person even prior to becoming a covered associate of the SBS Dealer, SBS Dealers need to "look back" in time to determine whether the two-year time out applies when an employee becomes a covered associate.[1117] Given that one commenter suggested further specificity as to whether the rule applies only to contributions made on or after the rules effective date,[1118] we are interpreting the prohibition in Rule 15Fh-6(b)(1) and its exceptions in Rule 15Fh-6(b)(2), as well as the restrictions on soliciting or coordinating contributions found in Rule 15Fh-6(b)(3), to not be triggered for an SBS Dealer or any of its covered associates by contributions made *before* the SBS Dealer registered with the Commission as such. This

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[1117] See Proposing Release, 76 FR at 42434, supra note 3. In the Proposing Release, we explained, as an example, that if the contribution at issue was made less than two years (or six months, as applicable under Rule 15Fh-6(b)(2)(ii)) before an individual becomes a covered associate, the 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. As noted above, Rule 15Fh-6(b)(2)(ii) provides an exception to the prohibition in Rule 15Fh-6(b)(1) such that the prohibition would not apply to contributions made by an individual 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.

[1118] See FIA/ISDA/SIFMA, supra note 5 (requesting clarification that "the rule would not unintentionally ban SBS activity as a result of contributions made during the pre-effectiveness period"). See also SIFMA (August 2015), supra note 5.

interpretation is, as one commenter noted, also consistent with CFTC No-Action relief.[1119] However, such prohibitions will apply to contributions made on or after the SBS Dealer is required to register with the Commission. We also note that these prohibitions do not apply to contributions made *before* the compliance date of this rule by new covered associates to which the rule's "look back" applies (i.e., a person who becomes a covered associate within two years after the contribution is made). This interpretation is similar to the approach taken by the Commission in connection with Advisers Act Rule 206(4)-5.[1120] For example, if an individual who becomes a covered associate on or after the effective date of the rule made a contribution *before* the effective date of the rule, that new covered associate's contribution would not trigger the two-year time out. On the other hand, if an individual who later becomes a covered associate made the contribution on or after the compliance date of this rule, the contribution would trigger the two-year time out if it were made less than, as applicable, six months or two years before the individual became a covered associate.[1121]

With respect to the comment recommending amending the proposed rule to include Major SBS Participants in the prohibitions of Rule 15Fh-6,[1122] the Commission does not believe that it is necessary or appropriate to do so. We have considered how the differences between the definitions of SBS Dealer and Major SBS Participant may be

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1119 See SIFMA (August 2015), supra note 5. See also CFTC Letter No. 12-33 (November 29, 2012).

1120 See Advisers Act Pay-to-Play Release, 75 FR at 41051, n.434, supra note 1100 (noting, similarly, that the prohibitions in Rule 206(4)-5 also do not apply to contributions made before the compliance date established for Rule 206(4)-5 by new covered associates to which the look back applies).

1121 See id. (providing similar examples in connection with Rule 206(4)-5).

1122 CFA, supra note 5.

relevant in formulating the business conduct standards applicable to these entities.[1123] The Commission does not believe it is necessary to revisit its assumption, outlined in the Proposing Release, that Major SBS Participants are unlikely to give rise to the pay-to-play concerns that this rule is intended to address.[1124] As discussed above, SBS Dealers may have an incentive to compete for security-based swap business based on their ability and willingness to participate in pay to play activity, rather than on their merit or the merit of a proposed transaction, out of concern that they may be overlooked if they fail to make such contributions. However, we believe the incentives for Major SBS Participants to engage in pay to play activity are unlikely to be as strong as the incentives for SBS Dealers given that, by definition, Major SBS Participants are not engaged in security-based swap dealing activity at levels above the de minimis threshold.[1125] As such, Major SBS Participants are less likely than SBS Dealers to be acting as dealers in the security-based swap market and, like any other person whose dealing activity does not exceed the dealer de minimis thresholds, should therefore be less susceptible to the types of competitive pressures that may create an incentive to participate in pay to play activity. We further note that, if a Major SBS Participant is, in fact, engaged in security-based

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1123 See, e.g., Section II.B (explaining that, unlike the definition of "security-based swap dealer," which focuses on the way a person holds itself out in the market and whose function is to serve as the point of connection in those markets, the definition of "major security-based swap participant," focuses on the market impacts and risks associated with an entity's security-based swap positions).

1124 See, e.g., MFA, supra note 5 (urging the Commission to consider separate regulatory regimes for SBS Dealers and Major SBS Participants, arguing that they are different, and there are "different reasons why the Dodd-Frank Act requires additional oversight of each").

1125 See Exchange Act rule 3a61-1(a)(1) (limiting the definition of "major security-based swap participant" to persons that are not security-based swap dealers).

swap dealing activity above the de minimis threshold, it would need to register as an SBS Dealer and, as such, would need to comply with the pay to play rules imposed by Rule 15Fh-6.

Therefore, SBS Dealers, unlike Major SBS Participants, may have an incentive to participate in pay to play practices out of concern that they may be overlooked if they fail to make such contributions which, in turn, would necessitate application of pay to play prohibitions. Furthermore, the exclusion of Major SBS Participants from Rule 15Fh-6 will also be consistent with the pay to play prohibition adopted by the CFTC.[1126] Substantial consistency across pay to play regulatory regimes will be helpful for those entities that have already established a regulatory infrastructure to comply with existing rules. One commenter suggested that, with respect to the proposal that independent representatives be subject to pay to play limitations, an exception is needed "for advisors that are employees of the special entity, given the employer-employee relationship."[1127] However, the Commission notes that the rules already include such an exception. As explained previously, Rule 15Fh-5(a)(1)(vi) as adopted requires 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.

1126 See CFTC Adopting Release, 77 FR at 9800, supra note 21.

1127 APPA, supra note 5.

The same commenter also urged the Commission, in a comment letter dated August 2011, to delay imposing the proposed pay to play rule until after the "dealer" definitions are finalized.[1128] As explained in Section IV.B below, the Commission is adopting a compliance date for final Rules 15Fh-1 through 15Fh-6 and Rule 15Fk-1 that is the same as the compliance date of the SBS Entity registration rules.[1129]

The Commission declines to revise Rule 15Fh-6, as one commenter suggested, by limiting the triggering event for the application of the pay to play rules to "engag[ing] in municipal security-based swap business" or "the execution of a security-based swap with a municipal entity."[1130] As explained in the Proposing Release, pay to play occurs when persons seeking to do business with municipal entities make political contributions, or are solicited to make political contributions, to elected officials or candidates to influence the selection process.[1131] Hence, pay to play could occur when an SBS Dealer is merely offering to enter into a security-based swap with a municipal entity, before that SBS Dealer has yet to actually enter into, engage in, or execute any such transaction. Rather, the SBS Dealer is seeking to influence the selection process to generate business. Therefore, the Commission believes that further parsing of the trigging event applicable

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1128 APPA, supra note 5.

1129 The Commission explained in the Registration Adopting Release that persons determined to be SBS Dealers or Major SBS Participants under those rules need not register as such until the dates provided for in the Commission's final rules regarding SBS Entity registration requirements, "and will not be subject to the requirements applicable to those dealers and major participants until the dates provided in the applicable final rules." Registration Adopting Release, supra note 989.

1130 FIA/ISDA/SIFMA, supra note 5 (suggesting that the Commission consider replacing the proposed "triggering occasion for the application of the rule").

1131 See Proposing Release, 76 FR at 42432, supra note 3.

to this rule, as suggested by the commenter, would create an unintended regulatory gap that would not capture those who offer to enter into a security-based swap transaction with a municipal entity with the hope that their contributions or payments will influence the selection process so that they may later enter into, engage in, or execute security-based swaps with that municipal entity. 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."[1132] Furthermore, this same suggestion was raised to and declined by the CFTC. [1133] As a result, the triggering event for the application of Rule 15Fh-6 is consistent with the CFTC's rule and substantially consistent with the trigging event for certain prohibitions found in the Commission's Advisers Act Rule 206(4)-5.[1134]

One commenter that addressed the definition of "solicit" in the proposed rule generally urged us to adopt a narrower definition.[1135] However, the Commission declines to revise Rule 15Fh-6 to further parse the definition of "solicit." We believe that it is unnecessary, as the commenter suggested, for the definition to cover only direct communications or to state what communications are *not* covered by the term

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1132 Id. (citing Blount, 61 F.3d at 945).

1133 See CFTC Adopting Release, 77 FR at 9799-800, supra note 21.

1134 See Advisers Act Rule 206(4)-5(2)(ii) (including, among other triggering activities, when the investment adviser is "providing or seeking to provide investment advisory services to a government entity").

1135 FIA/ISDA/SIFMA, supra note 5 (recommending that the Commission clarify the definition of "solicit" include only "any direct communication by any person with a municipal entity for the purpose of obtaining or retaining municipal security-based swap business").

"solicit."[1136] The proposed definition makes clear that to fall within its scope the communication, whether direct or indirect, must be "with a municipal entity for the purpose of obtaining or retaining an engagement related to a security-based swap." Further parsing and thus narrowing of the definition of "solicit" is unwarranted given the covert and secretive nature of pay to play practices where, as noted above, "actors in this field are presumably shrewd enough to structure their relations rather indirectly."[1137] Rule 15Fh-6 is intended to deter SBS Dealers from participating, even indirectly, in pay to play practices. The Commission believes that the definition of "solicit" is clear as to what communications are covered by the pay to play rule, and the definition is also consistent with the CFTC's rule and the Commission's definition of "solicit" in Advisers Act Rule 206(4)-5[1138] which, as noted above, Rule 15Fh-6 was modeled on and intended to complement.

Another commenter suggested that the Commission revise Rule 15Fh-6 to create a safe harbor from the pay to play rule for a special entity that is represented by a "qualified independent representative" that affirmatively selects the SBS Dealer.[1139] However, the Commission declines to create a safe harbor as the commenter suggested. For one, the commenter's argument that such a safe harbor would "assist municipal

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1136 See id. (suggesting that the rule should exclude any communication with a municipal entity for the sole purpose of obtaining or retaining any other type of business covered under pay-to-play restrictions because, in that commenter's view, such communications would already trigger pay-to-play restrictions under other regulations).

1137 Proposing Release, 76 FR at 42432, supra note 3 (citing Blount, 61 F.3d at 945).

1138 17 CFR 275.206(4)-5(f)(10)(i) (defining "solicit," in part, to mean "to communicate, directly or indirectly, for the purpose of obtaining or retaining a client for . . . an investment adviser").

1139 SIFMA (August 2011), supra note 5.

entities and their advisors by preserving their ability to execute security-based swap transactions" is not persuasive to support this suggested modification when, for example, one of the purposes behind this rule is the need for prophylactic measures to address stealthy pay to play practices.[1140] As stated in the Proposing Release and noted above, by its nature, pay to play is covert and secretive 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. The Commission believes that adopting such a safe harbor, as suggested, could create a means for would-be wrongdoers to covertly and secretively engage in pay to play practices by, among other things, using situations where the special entity, represented by a qualified independent representative, selects the SBS Dealer as a way to evade or otherwise circumvent the rule's prohibitions. The commenter's suggestion would also create a material difference between the regulatory regimes established by the Commission under the Advisers Act as well as the CFTC's rules and would decrease regulatory efficiencies for market participants.

Finally, we are not expressly excluding, as one commenter suggested, state-established plans that are managed by a third-party, such as 529 college savings plans, from the pay to play provisions.[1141] We do not find the commenter's unsupported claim that pay to play provisions will deter SBS Dealers from transacting business with such plans persuasive. More importantly, even if we were to accept this argument, the same concerns, outlined above, that we are attempting to address with these pay to play restrictions, including but not limited to the furtive nature of pay to play practices, are

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1140 Cf. Blount, 61 F.3d at 945 (noting that, with respect to pay to play practices "the likelihood of stealth great," while "the legislative purpose prophylactic").

1141 See SIFMA (August 2011), supra note 5.

also applicable for state-established plans that are managed by a third-party. As noted above, we believe that SBS Dealers may have an incentive to participate in pay to play practices, even in connection with state-established plans that are managed by a third-party, out of concern that they may be overlooked for business if they fail to make such contributions. We further believe these practices may result in significant harm to municipalities and others, including state-established plans, in connection with security-based swap transactions. Rule 15Fh-6(b)(3)(i) is intended to deter SBS Dealers from participating, even indirectly, in such practices.

I. 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.[1142]

1. Proposed Rule

a. Designation, Reporting Line, Compensation and Removal of the CCO

Proposed Rule 15Fk-1(a) would require an SBS Entity to designate a CCO on its registration form. Proposed Rule 15Fk-1(b)(1) would require that the CCO report directly to the board of directors or to the senior officer of the SBS Entity.[1143] Proposed Rule 15Fk-1(e)(1) would define "board of directors" to include a body performing a function similar to the board of directors. Proposed Rule 15Fk-1(e)(2) would define "senior officer" to mean the chief executive officer or other equivalent officer. 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.

1142 15 U.S.C. 78o-10(k).

1143 See Section 15F(k)(2)(A) of the Exchange Act, 15 U.S.C. 78o-10(k)(2)(A).

b. Duties of the CCO

Proposed Rule 15Fk-1(b) would impose certain duties on the CCO. 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.[1144] Proposed 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.

Proposed Rule 15Fk-1(b)(3) would require that the CCO, in consultation with the board of directors or the senior officer of the organization, promptly resolve conflicts of interest that may arise.[1145] 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 Exchange Act and the rules and regulations thereunder.[1146] 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.[1147] 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 through any compliance office

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1144 See Section 15F(k)(2)(B) of the Exchange Act, 15 U.S.C. 78o-10(k)(2)(B).

1145 See Section 15F(k)(2)(C) of the Exchange Act, 15 U.S.C. 78o-10(k)(2)(C).

1146 See Section 15F(k)(2)(D) of the Exchange Act, 15 U.S.C. 78o-10(k)(2)(D).

1147 See Section 15F(k)(2)(E) of the Exchange Act, 15 U.S.C. 78o-10(k)(2)(E).

review, look-back, internal or external audit finding, self-reporting to the Commission and other appropriate authorities, or complaint that can be validated.[1148] Proposed Rule 15Fk-1(e)(3) would define "complaint that can be validated" to mean any written complaint by a counterparty involving the SBS Entity or an associated person that can be supported upon reasonable investigation. Proposed Rule 15Fk-1(b)(7) would require the CCO to establish and follow procedures reasonably designed for prompt handling, management response, remediation, retesting, and resolution of non-compliance issues.[1149]

c. Annual Compliance Report

Proposed Rule 15Fk-1(c)(1) would require that the CCO annually prepare and sign a report describing the SBS Entity's compliance policies and procedures (including the code of ethics and conflicts of interest policies) and the compliance of the SBS Entity with the Exchange Act and rules and regulations thereunder relating to its business as an SBS Entity.[1150] Proposed Rule 15Fk-1(c)(2) would require that each compliance report also contain, at a minimum, a description of: (1) the SBS Entity's enforcement of its policies and procedures relating to its business as an SBS Entity; (2) any material changes to the policies and procedures since the date of the preceding compliance report; (3) any

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1148 See Section 15F(k)(2)(F) of the Exchange Act, 15 U.S.C. 78o-10(k)(2)(F).

1149 See Section 15F(k)(2)(G) of the Exchange Act, 15 U.S.C. 78o-10(k)(2)(G).

1150 See Section 15F(k)(3)(A) of the Exchange Act, 15 U.S.C. 78o-10(k)(3)(A). As noted in the Proposing Release, the Commission believes there is a drafting error in the reference to compliance of the "major swap participant" in Section 15F(k)(3)(A) of the Exchange Act, and accordingly, proposed Rule 15Fk-1(c)(1) would apply the requirement with respect to the compliance of the "major security-based swap participant." See Proposing Release, 76 FR at 42436 n.288, supra note 3.

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 (4) any material compliance matters identified since the date of the preceding compliance report. 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 to oversee the compliance of the SBS Entity, and that involves, without limitation: (1) 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; (2) a violation of the policies and procedures of the SBS Entity relating to its business as an SBS Entity by the SBS Entity or its officers, directors, employees or agents; or (3) a weakness in the design or implementation of the policies and procedures of the SBS Entity relating to its business as an SBS Entity.

Proposed Rule 15Fk-1(c)(2)(ii)(D) would require the compliance report to include a certification, under penalty of law, that the compliance report is accurate and complete.[1151] Proposed Rule 15Fk-1(c)(2)(ii)(A) would require that the compliance report accompany each appropriate financial report of the SBS Entity that is required to be furnished or filed with the Commission pursuant to Exchange Act Section 15F and the rules and regulations thereunder.[1152] To allow the compliance report to accompany each appropriate financial report within the required timeframe, proposed Rule 15Fk-1(c)(2)(ii)(B) would require the compliance report to be submitted to the board of

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[1151] See Section 15F(k)(3)(B)(ii) of the Exchange Act, 15 U.S.C. 78o-10(k)(3)(B)(ii).

[1152] See Section 15F(k)(3)(B)(i) of the Exchange Act, 15 U.S.C. 78o-10(k)(3)(B)(i).

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.

Proposed Rule 15Fk-1(c)(2)(ii)(C) would require the compliance report to include a written representation that the chief executive officer(s) (or equivalent officer(s)) has/have conducted one or more meetings with the CCO in the preceding 12 months, the subject of which addresses the SBS Entity's obligations as set forth in the proposed rules and in Exchange Act Section 15F. The subject of the meeting(s) must include: (1) the matters that are the subject of the compliance report; (2) the SBS Entity's compliance efforts as of the date of such meeting; and (3) significant compliance problems and plans in emerging business areas relating to its business as an SBS Entity.[1153]

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.

2. Comments on the Proposed Rule

a. Designation, Reporting Line, and Compensation and Removal of the CCO

Five commenters addressed the designation, reporting line and compensation and removal of the CCO.[1154] Two commenters argued for greater flexibility for SBS Entities with respect to these requirements.[1155] The first commenter objected to the mandated line

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1153 Id.

1154 See FIA/ISDA/SIFMA, supra note 5; CFA, supra note 5; Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5; Barnard, supra note 5; SIFMA (September 2015), supra note 5.

1155 See FIA/ISDA/SIFMA, supra note 5; SIFMA (September 2015), supra note 5.

of reporting of the CCO in the proposed rule (which would require the CCO to report directly to the board of directors or to the senior officer of the SBS Entity) and recommended allowing SBS Entities greater flexibility in determining the most effective reporting framework in light of their individual structure and circumstances.[1156] The commenter noted that, particularly in large institutions where security-based swap transactions are one of many lines of business, the proposed rule would prohibit the CCO from reporting to other senior management who may be more familiar with the security-based swap activities of the SBS Entity.[1157] Accordingly, the commenter recommended that the Commission define the term "senior officer" to include a more senior officer within the SBS Entity's compliance, risk, legal or other control function as the SBS Entity shall reasonably determine to be appropriate.[1158]

Similarly, the second commenter asked the Commission to provide guidance specifying that if a division of a larger company is an SBS Entity, then the CCO of such entity could report to the senior officer of that division.[1159] Additionally, the commenter requested guidance: (1) regarding the supervisory liability of compliance and legal personnel employed by SBS Entities that is consistent with the guidance it has issued for broker-dealers' legal and compliance personnel; and (2) clarifying that the CCO may share additional executive responsibilities within the SBS Entity.[1160]

Both commenters objected to the proposed requirement that the compensation and

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1156 See FIA/ISDA/SIFMA, supra note 5.

1157 Id.

1158 Id.

1159 See SIFMA (September 2015), supra note 5.

1160 Id.

removal of the CCO be approved by a majority of the SBS Entity's board of directors.[1161] The first commenter recommended eliminating the requirement, noting that the provision is not mandated by the Dodd-Frank Act, is not consistent with other requirements applicable to similarly situated employees, and would impose organizational inefficiencies and other unwarranted costs while offering minimal benefits.[1162] The second commenter recommended allowing either the board of directors or the senior officer of the SBS Entity to approve the compensation or removal of the CCO to be consistent with the parallel CFTC requirement, asserting that this change would reasonably ensure the independence and effectiveness of the CCO while providing for greater flexibility.[1163]

Three commenters argued for more stringent requirements with respect to the designation, reporting line and compensation and removal of the CCO.[1164] The first commenter asserted that ensuring market participants have CCOs with real authority and autonomy to police a firm from within is one of the most efficient and effective tools available to regulators, and accordingly, recommended adopting additional measures to protect the authority and independence of CCOs.[1165] Specifically, the commenter suggested: (1) requiring the CCO to meet competency standards, including a lack of disciplinary history and criteria demonstrating relevant knowledge and experience; (2)

1161 See FIA/ISDA/SIFMA, supra note 5; SIFMA (September 2015), supra note 5.

1162 See FIA/ISDA/SIFMA, supra note 5.

1163 See SIFMA (September 2015), supra note 5.

1164 See CFA, supra note 5; Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5; Barnard, supra note 5.

1165 See Better Markets (October 2013), supra note 5.

prohibiting the CCO from serving as General Counsel or a member of the legal department of the SBS Entity; (3) appointing a senior CCO with overall responsibility for compliance by a group of affiliated or controlled entities; (4) vesting authority in independent board members to oversee the hiring, compensation, and termination of the CCO; (5) requiring the CCO to have direct access to the board; and (6) prohibiting attempts by officers, directors, or employees to coerce, mislead, or otherwise interfere with the CCO.[1166]

Similarly, the second commenter recommended that the authority and responsibility to appoint or remove the CCO, or to materially change its duties and responsibilities, be vested only in the independent directors and not the full board.[1167] Additionally, the commenter suggested that the CCO have only a compliance role and no other role or responsibility that could create conflicts of interest or threaten its independence, and that the CCO's compensation be designed in a way that avoids conflicts of interest.[1168]

The third commenter asserted that firms should not be permitted to allow the CCO to report to a senior officer of the firm as a substitute for reporting to the board.[1169]

b. Duties of the CCO

Three commenters addressed the duties of the CCO.[1170] The first commenter

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1166 See Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5.

1167 See Barnard, supra note 5.

1168 Id.

1169 See CFA, supra note 5.

1170 See FIA/ISDA/SIFMA, supra note 5; SIFMA (September 2015), supra note 5; CFA, supra note 5.

supported the Commission's approach in the proposal regarding the role and responsibilities of the CCO, but recommended the following modifications: (1) changing the phrase "ensure compliance" in proposed Rule 15Fk-1(b)(5) to "achieve compliance," (2) confirming that the relevant conflicts of interest under proposed Rule 15Fk-1(b)(3) would be those which are reasonably identified by the SBS Entity's policies and procedures, taking into consideration the nature of the SBS Entity's business, and (3) clarifying that a CCO's responsibility under proposed Rule 15Fk-1(b)(4) to "administer" a firm's policies and procedures is limited to coordinating supervisors' administration of the relevant policies and procedures.[1171]

The second commenter recommended harmonizing the Commission's CCO requirements with FINRA Rule 3130 and the CFTC's CCO requirements for Swap Entities to enable SBS Entities that are also broker-dealers and/or Swap Entities to make use of their existing infrastructure and to minimize confusion.[1172] Specifically, the commenter recommended a number of changes to proposed Rule 15Fk-1(b) to align the description of the duties of an SBS Entity's CCO with those of a broker-dealer CCO, as described in applicable FINRA and SEC guidance, and guidance in the Proposing Release regarding the supervisory responsibilities of an SBS Entity's CCO.[1173] In particular, the commenter sought clarification that the SBS Entity has the responsibility, and not the CCO in his or her personal capacity, to establish, maintain and review

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1171 See FIA/ISDA/SIFMA, supra note 5.

1172 See SIFMA (September 2015), supra note 5.

1173 Id.

required policies and procedures.[1174] The recommended changes include: (1) replacing the requirement in proposed Rule 15Fk-1(b)(2) to "establish, maintain and review" written policies and procedures reasonably designed to achieve compliance with Section 15F of the Act and the rules and regulations thereunder with a requirement to "prepare the registrant's annual assessment of" such policies and procedures; (2) qualifying the requirement in proposed Rule 15Fk-1(b)(3) to promptly resolve conflicts of interest in consultation with the board of directors or the senior officer of the SBS Entity with the qualifying language "take reasonable steps to" resolve; (3) clarifying that the requirement in proposed Rule 15Fk-1(b)(4) to administer required policies and procedures involves "advising on the development of, and reviewing, the registrant's processes for (i) modifying those policies and procedures as business, regulatory and legislative changes and events dictate, (ii) evidencing supervision by the personnel responsible for the execution of those policies and procedures, and (iii) testing the registrant's compliance with those policies and procedures;" (4) qualifying the requirements in proposed Rules 15Fk-1(b)(5)-(7) to establish, maintain and review certain policies and procedures with the qualifying language "take reasonable steps to ensure that the registrant" establishes, maintains and reviews such policies and procedures; and (5) eliminating the timing requirements in proposed Rules 15Fk-1(b)(6) and (7) that the CCO "promptly" take the required actions.[1175] Finally, the commenter requested that the Commission provide guidance explaining that resolution of a conflict of interest encompasses both elimination and mitigation of the conflict, and that the CCO's role in resolving conflicts may involve

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1174 Id.

1175 Id.

actions other than making the ultimate decision with regard to such conflict.[1176]

In contrast, the third commenter recommended mandating that CCOs have greater authority to resolve and mitigate conflicts of interest that may cause compliance problems.[1177] At a minimum, the commenter suggested requiring the CCO to highlight in the compliance report any recommendations it made with regard to resolution or mitigation of conflicts of interest that were not adopted.[1178]

c. Annual Compliance Report

Four commenters addressed the annual compliance report requirements.[1179] One commenter noted several concerns with the annual compliance report requirement.[1180] First, the commenter requested that the Commission permit the consolidation of annual compliance reporting requirements for SBS Entities under common control (including those that are also registered broker-dealers) to avoid forcing a consolidated financial institution to submit separate compliance reports for each SBS Entity and broker-dealer within the corporate structure.[1181] Second, the commenter expressed concern regarding the requirement in proposed Rule 15Fk-1(c)(1)(i) that the compliance report contain a description of the compliance of the SBS Entity, as well as a description of the SBS Entity's compliance policies and procedures, as required under proposed Rule 15Fk-

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1176 Id.

1177 See CFA, supra note 5.

1178 Id.

1179 See FIA/ISDA/SIFMA, supra note 5; CFA, supra note 5; Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5; SIFMA (September 2015), supra note 5.

1180 See FIA/ISDA/SIFMA, supra note 5.

1181 Id.

1(c)(1)(ii).[1182] The commenter requested that the Commission clarify that proposed Rule 15Fk-1(c)(1)(i) would be satisfied by a description of the particular matters set forth in proposed Rule 15Fk-1(c)(2)(i), noting that a requirement to describe an SBS Entity's "compliance" in an absolute sense is so broad and so vague as to be incapable of being fulfilled in practice.[1183] Third, the commenter recommended that the Commission amend its Freedom of Information Act regulations in a manner consistent with proposed Rule 15Fk-1(c)(2)(iii), which would provide that compliance reports bound separately from financial statements shall be accorded confidential treatment to the extent permitted by law.[1184]

The commenter also had several concerns regarding the required certification of the compliance report in proposed Rule 15Fk-1(c)(2)(ii)(D).[1185] The commenter noted that the Dodd-Frank Act does not explicitly require the CCO to be the individual responsible for certifying the compliance report and recommended that the CEO or other relevant senior officer, not the CCO, be responsible for the certification.[1186] Alternatively, if the CCO is required to certify, the commenter requested that the CEO also be required to do so.[1187] Additionally, the commenter requested that the Commission clarify that the liability standard for the certification is the same as that which applies to other documents filed with the Commission, including liability under

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1182 Id.

1183 Id.

1184 Id.

1185 Id.

1186 Id.

1187 Id.

Section 32 of the Exchange Act for willfully and knowingly making false or misleading material statements or omissions to the Commission.[1188] The commenter also asserted that the certifier should, as in other contexts, be responsible solely for stating that the documents were prepared under his or her direction or supervision in accordance with a system designed to ensure that qualified personnel would properly gather and evaluate the documents, and that based on his or her inquiry of those persons who were responsible for gathering the documents, to the best of his or her knowledge, the documents are accurate in all material respects.[1189]

Similarly, the second commenter requested that the Commission provide guidance clarifying that if a certifying officer has complied in good faith with policies and procedures reasonably designed to confirm the accuracy and completeness of annual compliance report, both the SBS Entity and the certifying officer would have a basis for defending accusations of false, incomplete, or misleading statements or representations made in the report.[1190] The commenter also requested a number of changes to the annual compliance report requirements in proposed Rule 15Fk-1(c) to harmonize them with the CFTC's parallel requirements.[1191] The commenter argued that alignment of the content requirements for annual compliance reports "would allow SBS Entities to leverage the extensive and rigorous procedures they have adopted to comply with the CFTC CCO Rule and related guidance."[1192] Specifically, the recommended changes include: (1)

1188 Id.

1189 Id.

1190 See SIFMA (September 2015), supra note 5.

1191 Id.

1192 Id.

eliminating the proposed requirement to include a "description of compliance" in the annual compliance report, asserting that this requirement would add unnecessary ambiguity; (2) specifying that the report need only contain a description of the "written" compliance policies and procedures of the SBS Entity; (3) changing the proposed description requirement in proposed Rule 15Fk-1(c)(2)(i)(A) from "enforcement" of the SBS Entity's policies and procedures to an "assessment of the effectiveness" of such policies and procedures; (4) specifying that the requirement to describe material changes to policies and procedures in proposed Rule 15Fk-1(c)(2)(i)(B) refers to the "registrant's" policies and procedures; (5) changing the proposed description requirement in proposed Rule 15Fk-1(c)(2)(i)(C) from "any recommendation for material changes to the policies and procedures" to "areas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance;" (6) changing the proposed description requirement in proposed Rule 15F-1(c)(2)(i)(D) from "any material compliance matters" to "any material non-compliance matters" identified since the date of the preceding report (and eliminating the definition of material compliance matter); (7) aligning the deadline for filing of the compliance report with the CFTC's 90 day deadline; (8) allowing for submission of the compliance report to either the board of directors or the senior officer, as opposed to requiring submission to both the board of directors (and audit committee) and the senior officer, as proposed; (9) eliminating the proposed requirement that the report contain a written representation regarding the required annual meeting between the CEO and the CCO; (10) eliminating the proposed specifications for what topics such meeting must cover; (11) allowing either the CCO or the senior officer to certify the annual compliance report

to the best of his or her knowledge; and (12) providing for amendments to, extensions of filing deadlines for, and incorporation of other reports by reference in the annual compliance report.[1193]

The third commenter suggested: (1) requiring the CCO to meet quarterly with the Audit Committee in addition to annual meetings with the board of directors and senior management; and (2) requiring the board to review and comment on, but not edit, the compliance report.[1194] Similarly, the fourth commenter expressed support for requiring the audit committee to review and the CCO to certify the compliance report, and argued that the CCO should not be permitted to qualify its report.[1195]

3. Response to Comments and Final Rule

Rule 15Fk-1, as adopted, is designed to be generally consistent with the current compliance obligations applicable to CCOs of other Commission-regulated entities,[1196] as well as with the CFTC's CCO rules applicable to Swap Entities. As noted in the Proposing Release, the requirements of Rule 15Fk-1 underscore the central role that sound compliance programs play to help ensure compliance with the Exchange Act and

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1193 Id.

1194 See Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5.

1195 See CFA, supra note 5.

1196 See, e.g., FINRA Rule 3130; Rule 38a-1(a) under the Investment Company Act of 1940, 17 CFR 270.38a-1(a)(1); Rule 206(4)-7(a) under the Advisers Act, 17 CFR 275.206(4)-7(a); Rule 13n-11 under the Exchange Act, 17 CFR 240.13n-11.

rules and regulations thereunder applicable to security-based swaps.[1197] The Commission believes that these requirements will help foster sound compliance programs.[1198]

a. Designation, Reporting Line, and Compensation and Removal of the CCO

After considering the comments, the Commission is adopting Rule 15Fk-1(a) (designation of the CCO), Rule 15Fk-1(b)(1) (reporting line of the CCO), Rule 15Fk-1(d) (compensation and removal of the CCO), and the associated definitions of "board of directors" and "senior officer" in Rule 15Fk-1(e)(1) and (2) as proposed. To address concerns that an SBS Entity's commercial interests might have undue influence on a CCO's ability to make forthright disclosure to the board of directors or the senior officer about any compliance failures, the rule is designed to help promote CCO independence and effectiveness by establishing a direct reporting line to the board or senior officer, and by requiring compensation and removal decisions to be made by a majority of the board of directors. Accordingly, Rule 15Fk-1(b)(1) requires the CCO to report directly to the board or senior officer of the SBS Entity.[1199] In addition, pursuant to Rule 15Fk-1(d) any

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1197 See Proposing Release, 76 FR at 42435, supra note 3.

1198 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). 15 U.S.C. 78o-10(h)(1)(B) and 78o-10(h)(3)(D).

1199 One commenter recommended that the Commission define the term "senior officer" to include a more senior officer within the SBS Entity's compliance, risk, legal or other control function as the SBS Entity shall reasonably determine to be appropriate. See FIA/ISDA/SIFMA, supra note 5. The Commission declines to make this change because it could potentially undercut the independence of the CCO, and as noted above, the Commission believes it is important for the CCO to be independent to mitigate potential conflicts for the CCO in reporting or addressing compliance failures. Another commenter requested that the Commission provide guidance specifying that if a division of a larger company is an SBS Entity, then the CCO of such entity could report to the senior officer of

decision to remove the CCO from his or her responsibilities or approve his or her compensation must be made by a majority of the board. The Commission is not eliminating the requirement that only a majority of the board can approve the compensation or removal of the CCO, as suggested by one commenter,[1200] nor is the Commission broadening the rule to allow an SBS Entity's senior officer to approve the compensation and removal of the CCO, as suggested by another commenter.[1201] The Commission believes that eliminating the requirement that only a majority of the board can approve the compensation or removal of the CCO, or allowing an SBS Entity's senior officer to approve the compensation and removal of the CCO could undermine the CCO's independence and effectiveness, particularly if the CCO is responsible for reviewing the senior officer's compliance with the Exchange Act and the rules and regulations thereunder.[1202]

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that division. See SIFMA (September 2015), supra note 5. The Commission has not yet addressed a process through which firms could submit an application for limited designation as an SBS Entity, such as for a division within a larger company. See Registration Adopting Release, 80 FR at 48966 n.13, supra note 989 (addressing limited designation and registration).

1200 See SIFMA (September 2015), supra note 5.

1201 See FIA/ISDA/SIFMA, supra note 5.

1202 This is consistent with the position the Commission took in adopting CCO requirements for security-based swap data repositories ("SDRs"). See Security-Based Swap Data Repository Registration, Duties, and Core Principles, Exchange Act Release No. 74246 (Feb. 11, 2015), 80 FR 14438, 14507 (Mar. 19, 2015) ("SDR Registration Release") ("The Commission is not extending the applicability of this rule to an SDR's senior officer because the Commission believes that this may unnecessarily create conflicts of interest for the CCO, particularly if the CCO is subsequently responsible for reviewing the senior officer's compliance with the Exchange Act and the rules and regulations thereunder."). The Commission also declines to narrow the reporting line requirement to specify that the CCO must report only to the board of directors (and not the senior officer), as suggested by one commenter. See CFA, supra note

In promoting a CCO's independence and effectiveness, the Commission does not believe that it is necessary to adopt additional requirements suggested by commenters prohibiting a CCO from having additional roles or responsibilities outside of compliance, such as being a member of the SBS Entity's legal department or from serving as the SBS Entity's general counsel.[1203] To the extent that this poses a potential or existing conflict of interest, the Commission believes that an SBS Entity's written policies and procedures can be designed to adequately identify and mitigate any such conflict.[1204]

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5. Exchange Act Section 15F(k)(2)(A) gives SBS Entities the flexibility of allowing the CCO to report to either the board or senior officer, and the Commission believes that requiring a majority of the board to approve the compensation or removal of the CCO is sufficient to promote the independence of the CCO, allowing for greater flexibility in the reporting line.

1203 See Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5; Barnard, supra note 5. Cf. SIFMA (September 2015), supra note 5 (requesting clarification that the CCO may share additional executive responsibilities within the SBS Entity). The Commission is also not adopting a commenter's suggestion to require the appointment of a senior CCO with overall responsibility for compliance by a group of affiliated or controlled entities. See Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5. The Commission believes entities should have the flexibility to design their organizational structure to meet their business needs.

1204 As discussed in Section II.G.6, supra, Rule 15Fh-3(h)(2)(iii)(H) requires SBS Entities to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the supervisory system from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised. This is consistent with the position the Commission took in adopting CCO requirements for SDRs. See SDR Registration Release, 80 FR at 14507, supra note 1202 ("In promoting a CCO's independence and effectiveness, the Commission does not believe that it is necessary to adopt, as two commenters suggested, a rule prohibiting a CCO from being a member of the SDR's legal department or from serving as the SDR's general counsel. To the extent that this poses a potential or existing conflict of interest, the Commission believes that an SDR's written policies and procedures can be designed to adequately identify and mitigate any associated costs.").

The Commission also is not adopting rules requiring independent board members to oversee the hiring, compensation and termination of the CCO or any material changes to the CCO's duties, requiring the CCO to have direct access to the board, or expressly prohibiting attempts by officers, directors, or employees to coerce, mislead or otherwise interfere with the CCO, as suggested by commenters.[1205] The Commission continues to believe that requiring a majority of the board to approve the compensation and removal of the CCO is appropriate to promote the CCO's independence and effectiveness, and believes that it is appropriate not to provide for additional requirements such as those suggested by the commenters.[1206] With this approach, the Commission intends to promote the independence and effectiveness of the CCO while also providing SBS Entities flexibility in structuring their businesses and directing their compliance resources.

One commenter suggested requiring the CCO to meet certain competency standards, including criteria demonstrating relevant knowledge and experience.[1207] Given the critical role that a CCO is intended to play in helping to ensure an SBS Entity's compliance with the Exchange Act and the rules and regulations thereunder, the Commission believes that an SBS Entity's CCO generally should be competent and knowledgeable regarding the federal securities laws, empowered with full responsibility

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1205 See Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5; Barnard, supra note 5.

1206 The Commission also believes that requiring a majority of the board to approve the compensation of the CCO will address a commenter's concern regarding designing the compensation of the CCO in a way that avoids conflicts of interest. See Barnard, supra note 5.

1207 See Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5.

and authority to develop appropriate policies and procedures for the SBS Entity, as necessary, and responsible for monitoring compliance with the SBS Entity's policies and procedures adopted pursuant to rules under the Exchange Act.[1208] However, we believe that such considerations are properly vested in the SBS Entity, based on the particulars of its business, and thus, the Commission is not adopting specific requirements concerning the background, training or business experience for a CCO.

Another commenter asked that the Commission provide guidance regarding the supervisory liability of compliance and legal personnel employed by SBS Entities to reflect the guidance Commission staff has issued for broker-dealers' legal and compliance personnel.[1209] The Commission recognizes that compliance and legal personnel play a critical role in efforts by regulated entities to develop and implement effective compliance systems, including by providing advice and counsel to business line personnel. As noted in the Proposing Release, the title of CCO does not, in and of itself, carry supervisory responsibilities, and a CCO does not become a "supervisor" solely

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1208 This is generally consistent with the position the Commission took in adopting CCO requirements for SDRs. See SDR Registration Release, 80 FR at 14510, supra note 1202 ("Given the critical role that a CCO is intended to play in ensuring an SDR's compliance with the Exchange Act and the rules and regulations thereunder, the Commission believes that an SDR's CCO should be competent and knowledgeable regarding the federal securities laws, should be empowered with full responsibility and authority to develop and enforce appropriate policies and procedures for the SDR, as necessary, and should be responsible for monitoring compliance with the SDR's policies and procedures adopted pursuant to rules under the Exchange Act. However, the Commission will not substantively review a CCO's competency, and is not requiring any particular level of competency or business experience for a CCO.").

1209 See SIFMA (September 2015), supra note 5 (referencing Division of Trading and Markets Frequently Asked Questions about Liability of Compliance and Legal Personnel at Broker-Dealers under Sections 15(b)(4) and 15(b)(6) of the Exchange Act (Sept. 30, 2013), available at: http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm).

because he or she has provided advice or counsel concerning compliance or legal issues to business line personnel, or assisted in the remediation of an issue. Consistent with current industry practice, the Commission generally would not expect a CCO appointed in accordance with Rule 15Fk-1 to have supervisory responsibilities outside of the compliance department.[1210] Accordingly, absent facts and circumstances that establish otherwise, the Commission generally would not expect that a CCO would be subject to a sanction by the Commission for failure to supervise other SBS Entity personnel.[1211] Moreover, a CCO with supervisory responsibilities could rely on the provisions of 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 the conditions in the rule are met.[1212] The fact that the Exchange Act does not presume that compliance or legal personnel are supervisors solely because of their compliance or legal functions does not in any way diminish the compliance duties of the CCO pursuant to Rule 15Fk-1(b), as discussed below.

b. Duties of the CCO

After considering the comments, the Commission is adopting Rule 15Fk-1(b)(2)-(4) (duties of the CCO) with a number of modifications. In response to a commenter's concerns,[1213] the modifications (discussed below) are primarily intended to provide certainty regarding the CCO's duties under the final rule, consistent with the duties in

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1210 See Proposing Release, 76 FR at 42436, supra note 3.

1211 Id. Regardless of their status as supervisors, compliance and legal personnel who otherwise violate the federal securities laws or aid and abet or cause a violation may independently be held liable for such violations.

1212 See Proposing Release, 76 FR at 42436, supra note 3.

1213 See SIFMA (September 2015), supra note 5.

FINRA Rule 3130 and the CFTC's CCO requirements for Swap Entities, and to clarify the role of the CCO generally. To the extent our requirements are consistent with FINRA and/or CFTC standards, this consistency should result in efficiencies for SBS Entities that have already established infrastructure to comply with the FINRA and/or CFTC standards. Consistent wording regarding expectations for CCOs will also allow such SBS Entities to more easily analyze compliance with the Commission's rule against their existing activities to comply with FINRA Rule 3130 and the CFTC's CCO rule for Swap Entities.

First, we are reorganizing Rule 15Fk-1(b)(2) to provide additional clarity and certainty as to the obligations of the CCO. Specifically, our modifications are designed to make clear that in taking reasonable steps to ensure that the SBS Entity establishes, maintains and reviews written policies and procedures reasonably designed to achieve compliance with the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity, the CCO must satisfy the three specific obligations enumerated in Rule 15Fk-1(b)(2)(i)–(iii), discussed below.

Second, in addition to the reorganization described above, we are making some changes to the descriptions of the duties listed in Rule 15Fk-1(b)(2). As described above, we are making changes to the duty that now appears in Rule 15Fk-1(b)(2). Specifically, the Commission agrees with a commenter that it is the responsibility of the SBS Entity, not the CCO in his or her personal capacity, to establish and enforce required policies and procedures.[1214] Accordingly, to reflect that, the Commission is qualifying the proposed requirement to establish, maintain and review policies and procedures reasonably

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[1214] See SIFMA (September 2015), supra note 5.

designed to ensure compliance with the Exchange Act and rules and regulations thereunder with the qualifying language "take reasonable steps to ensure that the registrant" establishes, maintains and reviews such policies and procedures. The Commission is also changing the requirement in Rule 15Fk-1(b)(2) from a requirement to "ensure compliance" to a requirement to "achieve compliance" with the Exchange Act and rules and regulations thereunder relating to the SBS Entity's business as an SBS Entity in response to a specific suggestion from a commenter,[1215] and adding the word "written" before policies and procedures to clarify that the policies and procedures required by the rule must be written. Similar to the qualifying language with respect to the registrant's policies and procedures, the Commission is making the change from "ensure compliance" to "achieve compliance" to clarify that it is not the role of the CCO to "ensure" compliance. The Commission believes the formulation "take reasonable steps to ensure that the registrant establishes, maintains and reviews written policies and procedures reasonably designed to achieve compliance" (as opposed to the proposed formulation of "establish, maintain and review policies and procedures reasonably designed to ensure compliance") more appropriately describes the CCO's role. The Commission also notes that the policies and procedures referred to in Rule 15Fk-1(b)(2) include those required by Rules 15Fh-3(h)(2)(iii), 15Fk-1(b)(2)(ii) and 15Fk-1(b)(2)(iii), and any other policies and procedures the SBS Entity deems necessary to achieve compliance with the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity.

[1215] See FIA/ISDA/SIFMA, supra note 5.

We are also modifying the three specific obligations of the CCO now enumerated in Rule 15Fk-1(b)(2)(i)–(iii) that the CCO must perform to satisfy his or her duty to take reasonable steps to ensure that the registrant establishes, maintains and reviews policies and procedures reasonably designed to achieve compliance. As adopted, Rule 15Fk-1(b)(2)(i) requires the CCO to "revie[w] the compliance of the [SBS Entity] with respect to the [SBS Entity] requirements described in [S]ection 15F of the [Exchange Act], and the rules and regulations thereunder, where the review shall involve preparing the registrant's annual assessment of its written policies and procedures reasonably designed to achieve compliance with [S]ection 15F of the [Exchange Act] and the rules and regulations thereunder, by the [SBS Entity]." The requirement that the CCO "prepare the registrant's annual assessment of its" written policies and procedures reasonably designed to achieve compliance with Section 15F of the Exchange Act and the rules and regulations thereunder represents a change from the proposed requirement that the CCO "establish, maintain and review" such policies and procedures. We are making this change in response to a specific suggestion from a commenter.[1216] As discussed above, the Commission agrees with the commenter that it is the responsibility of the SBS Entity, not the CCO in his or her personal capacity, to establish and enforce required policies and procedures, and believes that this change clarifies that point.

As adopted, Rule 15Fk-1(b)(2)(ii) requires the CCO to "tak[e] reasonable steps to ensure that the registrant establishes, maintains and reviews policies and procedures reasonably designed to remediate non-compliance issues identified by the [CCO] through any means, including any: (A) Compliance office review; (B) Look-back; (C) Internal or

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[1216] See SIFMA (September 2015), supra note 5.

external audit finding; (D) Self-reporting to the Commission and other appropriate authorities; or (E) Complaint that can be validated." This represents a change from the proposed requirements: (1) that the CCO "establish, maintain and review" such policies and procedures, and (2) that such policies and procedures be reasonably designed to remediate "promptly" non-compliance issues. Additionally, as adopted, Rule 15Fk-1(b)(2)(iii) requires the CCO to "tak[e] reasonable steps to ensure that the registrant establishes and follows procedures reasonably designed for the handling, management response, remediation, retesting, and resolution of non-compliance issues." This also represents a change from the proposed requirements: (1) that the CCO "establish and follow" such procedures, and (2) that such procedures be reasonably designed for the "prompt" handling, management response, remediation, retesting, and resolution of non-compliance issues." We are making these changes in response to specific suggestions from a commenter.[1217] As discussed above, the Commission agrees with the commenter that it is the responsibility of the SBS Entity, not the CCO in his or her personal capacity, to establish and enforce required policies and procedures, and believes that the first change to each provision clarifies that point. Additionally, as discussed above, eliminating the proposed timing requirements with respect to the "prompt" remediation and handling of non-compliance issues provides greater consistency with the parallel CFTC requirements. With this change, the Commission intends to focus the CCO's efforts on the effective remediation and handling of non-compliance issues, without placing undue emphasis on speed at the expense of other factors. We believe, however,

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[1217] See SIFMA (September 2015), supra note 5.

that the remediation and handling of non-compliance issues generally should occur within a reasonable timeframe.

In addition to the changes described above, the Commission is making one more modification to the duty to remediate non-compliance issues in final Rule 15Fk-1(b)(2)(ii). The proposed rule referred only to non-compliance issues "identified by the [CCO] through any: (A) Compliance office review; (B) Look-back; (C) Internal or external audit finding; (D) Self-reporting to the Commission and other appropriate authorities; or (E) Complaint that can be validated." However, as noted above, Rule 15Fk-1(b)(2)(iii) requires that the CCO "tak[e] reasonable steps to ensure that the registrant establishes and follows procedures reasonably designed for the handling, management response, remediation, retesting, and resolution of non-compliance issues" (emphasis added). Because this requirement is not limited to non-compliance issues identified by the CCO through a specific means, the Commission believes it is appropriate to clarify that final Rule 15Fk-1(b)(2)(ii) covers non-compliance issues identified by the CCO through any means, including the means specifically listed in sub-paragraphs (A)-(E) of the rule.

Third, the Commission is modifying the duties of the CCO now enumerated in Rules 15Fk-1(b)(3) and (4). As adopted, Rule 15Fk-1(b)(3) requires the CCO to "[i]n consultation with the board of directors or the senior officer of the [SBS Entity], take reasonable steps to resolve any material conflicts of interest that may arise." This represents a change from the proposed requirement, which would have required the CCO to "[i]n consultation with the board of directors or the senior officer of the [SBS Entity], promptly resolve any conflicts of interest that may arise." The Commission is adding the

"take reasonable steps" language and materiality qualifier to further clarify and qualify the role of the CCO in resolving conflicts of interest in response to concerns raised by commenters.[1218] Such conflicts of interest could include conflicts between the commercial interests of an SBS Entity and its statutory and regulatory responsibilities, and conflicts between, among, or with associated persons of the SBS Entity. As noted in the Proposing Release and consistent with the discussions of the CCO's role above, the Commission understands that the primary responsibility for the resolution of conflicts generally lies with the business units within SBS Entities because the business line personnel are those with the power to make decisions regarding the business of the SBS Entity.[1219] As a result, the Commission anticipates 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 responsibility to execute the business actions that may be associated with the ultimate resolution of such conflicts. Furthermore, the Commission recognizes that a CCO typically will not exercise the supervisory authority to resolve conflicts of interest,

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[1218] See FIA/ISDA/SIFMA, supra note 5 (requesting confirmation that the relevant conflicts of interest under proposed Rule 15Fk-1(b)(3) would be those which are reasonably identified by the SBS Entity's policies and procedures, taking into consideration the nature of the SBS Entity's business); SIFMA (September 2015), supra note 5 (recommending qualifying the requirement to promptly resolve conflicts of interest in consultation with the board or senior officer with the qualifying language "take reasonable steps to" resolve, and requesting guidance explaining that resolution of a conflict of interest encompasses both elimination and mitigation of the conflict and that the CCO's role in resolving conflicts may involve actions other than making the ultimate decision with regard to such conflict).

[1219] See Proposing Release, 76 FR at 42436, supra note 3.

and the revisions to the rule are intended to clarify that CCOs are not required to actually resolve such conflicts.[1220] Finally, in response to a specific suggestion made by a commenter,[1221] the Commission is eliminating the proposed timing requirement with respect to the "prompt" resolution of conflicts of interest to harmonize with the parallel CFTC requirement. With this change, the Commission intends to focus the CCO's efforts on the effective resolution of conflicts of interest, without placing undue emphasis on speed at the expense of other factors. We believe, however, that the resolution of conflicts of interest generally should occur within a reasonable timeframe.

As adopted, Rule 15Fk-1(b)(4) requires the CCO to "[a]dminister each policy and procedure that is required to be established pursuant to [S]ection 15F of the [Exchange Act] and the rules and regulations thereunder." This represents a change from the proposed requirement that the CCO "be responsible for" administering such policies and procedures. The Commission is eliminating the words "be responsible for" because we believe they are unnecessary and could cause confusion. The CCO is responsible for

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1220 This is consistent with the position the Commission took in adopting a similar requirement for CCOs of SDRs. See SDR Registration Release, 80 FR at 14510, supra note 1202. The Commission is not, as suggested by one commenter, expressly requiring the CCO to highlight in the annual compliance report any recommendations he or she made with regard to resolution or mitigation of conflicts of interest that were not adopted. See CFA, supra note 5. The Commission believes the requirement in Rule 15Fk-1(c)(2)(i)(C) to include a description in the annual compliance report of areas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources, as discussed below, will adequately cover such issues. The requirement is broadly framed and will allow the CCO the flexibility to include in the annual compliance report a description of any areas where the CCO thinks the compliance program needs to be improved, including, as appropriate, any recommendations the CCO made with regard to the resolution or mitigation of conflicts of interest that have not yet been adopted.

1221 See SIFMA (September 2015), supra note 5.

complying with all of the duties listed in Rule 15Fk-1(b)(2)-(4). Commenters requested clarifications as to what the CCO's administration of the required policies and procedures would entail.[1222] The Commission recognizes that the CCO cannot be a guarantor of the SBS Entity's conduct. The Commission believes that such administration generally should involve: (1) reviewing, evaluating, and advising the SBS Entity and its risk management and compliance personnel on the development, implementation and monitoring of the policies and procedures of the SBS Entity, including procedures reasonably designed for the handling, management response, remediation, retesting and resolution of non-compliance issues as required by Rule 15Fk-1(b)(2)(iii); and (2) reviewing, evaluating, following and reasonably responding to the development, implementation and monitoring of the SBS Entity's processes for (a) modifying its policies and procedures as business, regulatory and legislative changes dictate; (b) evidencing supervision by the personnel responsible for the execution of its policies and procedures; (c) testing the SBS Entity's compliance with, and the adequacy of, its policies and procedures; and (d) resolving, escalating and reporting issues or concerns. In carrying out this administration, the Commission believes that the CCO generally

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1222 See SIFMA (September 2015), supra note 5 (requesting the addition of rule text explaining that "such administration shall involve advising on the development of, and reviewing, the registrant's processes for (i) modifying those policies and procedures as business, regulatory and legislative changes and events dictate, (ii) evidencing supervision by the personnel responsible for the execution of those policies and procedures, and (iii) testing the registrant's compliance with those policies and procedures"); FIA/ISDA/SIFMA, supra note 5 (requesting clarification that a CCO's responsibility to administer a firm's policies and procedures is limited to coordinating supervisors' administration of the relevant policies and procedures).

should consult, as appropriate, with business lines, management and independent review groups regarding resolution of compliance issues.

c. Annual Compliance Report

After considering the comments, the Commission is adopting Rule 15Fk-1(c) (annual compliance report) with a number of modifications, as discussed below. In response to concerns raised by a commenter,[1223] these changes are primarily intended to harmonize the annual compliance report requirements with the CFTC's parallel requirements. As discussed above, this consistency will result in efficiencies for SBS Entities that have already established infrastructure to comply with the CFTC requirements. Consistent wording regarding expectations for the annual compliance report will also allow such SBS Entities to more easily analyze compliance with the Commission's rule against their existing activities to comply with the CFTC's parallel rule for Swap Entities.

First, the Commission is making a clarifying change to Rule 15Fk-1(c)(1) to consistently refer to the annual report required by Rule 15Fk-1(c) as the "compliance report." This wording change will not alter the substantive requirements of the rule. It is only meant to clarify that the rule refers to a single annual compliance report. Second, the Commission is eliminating the proposed requirement to include a description of "the compliance" of the SBS Entity in the annual compliance report in response to concerns raised by commenters,[1224] and specifying that the requirement to include a description of the compliance policies and procedures only requires a description of the "written"

1223 See SIFMA (September 2015), supra note 5.

1224 See SIFMA (September 2015), supra note 5; FIA/ISDA/SIFMA, supra note 5.

compliance policies and procedures of the SBS Entity pursuant to Rule 15Fk-1(c)(1), in response to a specific suggestion from a commenter.[1225] The Commission agrees with commenters that the proposed requirement to describe "the compliance" of the SBS Entity was vague and believes these clarifying changes will facilitate SBS Entities' compliance with the rule, which will still require an SBS Entity to provide information demonstrating how the SBS Entity complies with the applicable requirements of the Exchange Act and the rules and regulations thereunder in the form of the SBS Entity's written compliances policies and procedures. As adopted, Rule 15Fk-1(c)(1) requires the CCO to "annually prepare and sign a compliance report that contains a description of the written policies and procedures of the [SBS Entity] described in paragraph (b) (including the code of ethics and conflict of interest policies)." The Commission believes that SBS Entities can fulfill this requirement by either providing copies or summaries of their written compliance policies and procedures in the annual compliance report. These changes will also harmonize the annual compliance report requirements with the CFTC's parallel requirements, as discussed above.

The Commission is also making certain modifications to the required content of the annual compliance report in Rule 15Fk-1(c)(2) in response to specific suggestions from a commenter.[1226] First, the Commission is specifying that the requirement to describe material changes to policies and procedures since the date of the preceding

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1225 See SIFMA (September 2015), supra note 5. Cf. Commodity Exchange Act Rule 3.3(e)(1) ("The annual report shall, at a minimum…[c]ontain a description of the written policies and procedures, including the code of ethics and conflicts of interest policies, of the futures commission merchant, swap dealer, or major swap participant.").

1226 See SIFMA (September 2015), supra note 5.

compliance report in Rule 15Fk-1(c)(2)(i)(B) refers to the "registrant's" policies and procedures. This is a clarification and does not change the substance of the requirement. The phrase "since the date of the preceding compliance report" in the rule refers to the coverage date of the prior year's compliance report, not the date on which it was prepared. Accordingly, pursuant to Rule 15Fk-1(c)(2)(i)(B), as adopted, an SBS Entity must describe in its annual compliance report any material changes to the SBS Entity's policies and procedures for the time period covered by the report.

Second, the Commission is making a number of changes to harmonize the content requirements for the annual compliance report with the CFTC's parallel requirements for the annual compliance reports of Swap Entities. The Commission agrees with the commenter that alignment of the content requirements will allow SBS Entities that are also registered as Swap Entities to leverage the procedures they have adopted to comply with the CFTC's parallel CCO rule.[1227] Specifically, the Commission is changing the proposed requirement in Rule 15Fk-1(c)(2)(i)(A) that the annual compliance report contain a description of the "enforcement" of the SBS Entity's policies and procedures to an "assessment of the effectiveness" of such policies and procedures.[1228] The Commission believes that an "assessment of the effectiveness" of the SBS Entity's policies and procedures is a more appropriate description because the Commission is looking for a self-evaluation in the annual compliance report, not a detailed description of the mechanisms through which the SBS Entity's policies and procedures are enforced.

1227 See SIFMA (September 2015), supra note 5.

1228 Cf. Commodity Exchange Act Rule 3.3(e)(2)(ii) ("The annual report shall, at a minimum…[r]eview each applicable requirement under the Act and Commission regulations, and with respect to each…[p]rovide an assessment as to the effectiveness of these policies and procedures.").

Additionally, the Commission believes that providing consistency with the parallel CFTC requirement will allow SBS Entities to leverage any existing procedures, as discussed above.

The Commission is also changing the proposed requirement in Rule 15Fk-1(c)(2)(i)(C) that the annual compliance report contain a description of "any recommendation for material changes to the policies and procedures" to a requirement to describe "areas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance."[1229] As discussed above, this change is in response to a specific suggestion from a commenter.[1230] A description of "areas for improvement, and recommended potential or prospective changes or improvements to [an SBS Entity's] compliance program and resources devoted to compliance" is broader and would include any recommendations made by the CCO with respect to material changes to the SBS Entity's compliance policies and procedures. Accordingly, the Commission does not believe this wording change diminishes the scope of the required content of the annual compliance report. At the same time, however, this wording change makes the rule consistent with the parallel CFTC requirements and thus will allow SBS Entities to leverage any existing procedures, as discussed above.

1229 Cf. Commodity Exchange Act Rule 3.3(e)(2)(iii) ("The annual report shall, at a minimum…[r]eview each applicable requirement under the Act and Commission regulations, and with respect to each…[d]iscuss areas for improvement, and recommend potential or prospective changes or improvements to its compliance program and resources devoted to compliance.").

1230 See SIFMA (September 2015), supra note 5.

Additionally, the Commission is changing the proposed requirement that the annual compliance report contain a description of "any material compliance matters identified since the date of the preceding compliance report" to a requirement to describe "any material non-compliance matters identified" in Rule 15Fk-1(c)(2)(i)(D).[1231] The change from "material compliance matter" to "material non-compliance matter" is in response to a specific suggestion from a commenter.[1232] It is not a substantive change and is simply intended to provide consistency with the parallel CFTC requirement to allow SBS Entities to leverage any existing procedures, as discussed above. The Commission is also otherwise adopting the definition of material non-compliance matter in Rule 15Fk-1(e)(4), as proposed.[1233] The elimination of the phrase "since the date of the preceding compliance report" in the final rule is also intended to harmonize with the parallel CFTC requirement and respond to commenters' general concerns regarding consistency with parallel CFTC requirements.[1234] Additionally, with this change, the Commission intends to clarify that the annual compliance report should describe both material non-compliance matters that are newly identified during the time period covered

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1231 Cf. Commodity Exchange Act Rule 3.3(e)(5) ("The annual report shall, at a minimum…[d]escribe any material non-compliance issues identified, and the corresponding action taken.").

1232 See SIFMA (September 2015), supra note 5.

1233 The Commission declines to eliminate the definition of material non-compliance matter to be consistent with the CFTC's parallel requirement (which does not contain a definition), as suggested by a commenter. See SIFMA (September 2015), supra note 5. The Commission believes it is important to provide an explanation in the rule of what should be included in the annual compliance report.

1234 See, e.g., Barnard, supra note 5; Levin, supra note 5; BlackRock, supra note 5; Nomura, supra note 5.

by the report and previously identified material non-compliance matters that have not yet been resolved as of the end of the time period covered by the report.

Finally, the Commission is adding a requirement in Rule 15Fk-1(c)(2)(i)(E) for an SBS Entity to include a description in its annual compliance report of the "financial, managerial, operational, and staffing resources set aside for compliance with the [Exchange Act] and the rules and regulations thereunder relating to [the SBS Entity's] business as [an SBS Entity], including any material deficiencies in such resources."[1235] The Commission is adding this requirement to harmonize with the CFTC's parallel content requirement for the annual compliance reports of Swap Entities, and to respond to commenters' general concerns regarding consistency with parallel CFTC requirements.[1236] The Commission believes that a description of an SBS Entity's compliance resources and any deficiencies in such resources will be useful in assessing the compliance of the SBS Entity.

The Commission is also making a number of changes with respect to the submission of the annual compliance report. First, the Commission is aligning the deadline for submitting the report with the CFTC's deadline of 90 days after the end of the Swap Entity's fiscal year in response to concerns raised by a commenter.[1237] As

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1235 Cf. Commodity Exchange Act Rule 3.3(e)(4) ("The annual report shall, at a minimum…[d]escribe the financial, managerial, operational, and staffing resources set aside for compliance with respect to the [Commodity Exchange Act] and [CFTC] regulations, including any material deficiencies in such resources.").

1236 See, e.g., Barnard, supra note 5; Levin, supra note 5; BlackRock, supra note 5; Nomura, supra note 5.

1237 See SIFMA (September 2015), supra note 5; No-Action Relief for Futures Commission Merchants, Swap Dealers, and Major Swap Participants from Compliance with the Timing Requirements of Commission Regulation 3.3(f)(2) Relating to Annual Reports by Chief Compliance Officers, CFTC Letter No. 15-

adopted, Rule 15Fk-1(c)(2)(ii)(A) will require an SBS Entity's compliance report to "be submitted to the Commission within 30 days following the deadline for filing the [SBS Entity's] annual financial report with the Commission pursuant to Section 15F of the Act and rules and regulations thereunder."[1238] This represents a change from the proposed requirement that the compliance report "[a]ccompany each appropriate financial report of the [SBS Entity] that is required to be furnished to or filed with the Commission pursuant to Section 15F of the Act and rules and regulations thereunder." In response to concerns raised by a commenter, this change will provide SBS Entities with additional time to prepare their annual compliance reports after they have filed their annual financials.[1239] The Commission proposed a 60 day deadline from the end of the SBS Entity's fiscal year for the filing of an SBS Entity's annual financials, so to the extent the Commission adopts its proposed deadline for the annual financials, this change should also result in consistency with the CFTC's 90 day deadline for furnishing the annual compliance report.[1240]

Second, in connection with the change described above, the Commission is eliminating the proposed provision that "[i]f compliance reports are separately bound from the financial statements, the compliance reports shall be accorded confidential

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15 (Mar. 27, 2015), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-15.pdf.

1238 Section 15F(k)(3)(B)(i) of the Exchange Act provides that a compliance report shall "accompany each appropriate financial report of the [SBS Entity] that is required to be furnished to the Commission pursuant to this section." 15 U.S.C. 78o-10(k)(3)(B)(i). The Commission is interpreting "accompany" in Section 15F(k)(3)(B)(i) to mean follow within 30 days.

1239 See SIFMA (September 2015), supra note 5.

1240 See Recordkeeping Release, 79 FR at 25135, supra note 242.

treatment to the extent permitted by law." The Commission believes this provision is no longer necessary in light of the changes we are making to Rule 15Fk-1(c)(2)(ii)(A), discussed above, which will no longer require the compliance report to accompany the SBS Entity's financial report. SBS Entities may request confidential treatment for their annual compliance reports pursuant to Exchange Act Rule 24b-2.[1241]

Third, in response to comment,[1242] the Commission is adding a new Rule 15Fk-1(c)(2)(iii) allowing an SBS Entity to request from the Commission an extension of the deadline for submitting its annual compliance report to the Commission. The Commission agrees with the commenter that it is appropriate to establish a framework for when an SBS Entity is unable to meet the deadline. Pursuant to Rule 15Fk-1(c)(2)(iii), an SBS Entity may request an extension, provided that the SBS Entity's failure to timely submit the report could not be eliminated without unreasonable effort or expense. Extensions of the deadline will be granted at the discretion of the Commission. Rule 15Fk-1(c)(2)(iii) will also be consistent with CFTC rules regarding extensions of deadlines for compliance reports by Swap Entities.[1243]

Fourth, the Commission is changing the required timing of submission of the compliance report to the board of directors, audit committee and senior officer of the SBS

1241 See 17 CFR 240.24b-2. The change to the rule renders moot a commenter's request that the Commission amend its FOIA regulations in a manner consistent with proposed Rule 15Fk-1(c)(2)(iii). See FIA/ISDA/SIFMA, supra note 5.

1242 See SIFMA (September 2015), supra note 5.

1243 See Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants, 77 FR 20128, 20201 (Apr. 3, 2012) ("CFTC CCO Adopting Release").

Entity. The timing requirement in proposed Rule 15Fk-1(c)(3)(ii)(B) ("at the earlier of their next scheduled meeting or within 45 days of the date of execution of the required certification") was based on the timeframe provided in the FINRA rule regarding annual certification of compliance and supervisory processes.[1244] The FINRA rule allows for submission of the compliance report to the board of directors either before or after execution of the required certification.[1245] The Commission understands, however, that prudent corporate governance generally would require submission to the board of directors and senior officer before the execution of the certification. Accordingly, as adopted, Rule 15Fk-1(c)(2)(ii)(B) requires that the compliance report be submitted to the board of directors, audit committee and senior officer of the SBS Entity "prior to submission to the Commission." This timing requirement will be consistent with both Commission rules regarding compliance reports by SDRs and CFTC rules regarding compliance reports by Swap Entities.[1246] This consistency with CFTC requirements will allow SBS Entities to leverage any existing procedures, as discussed above.

The Commission declines to modify this provision, as suggested by a commenter, to allow for submission of the compliance report to either the board or the senior officer.[1247] The Commission believes that requiring submission to the board, audit committee and senior officer will promote an effective compliance system by ensuring that all of these groups, not just the senior officer, have the opportunity to review the

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1244 See FINRA Rule 3130(c).

1245 Id.

1246 See SDR Registration Release, 80 FR at 14512, supra note 1202; CFTC CCO Adopting Release, 77 FR at 20201, supra note 1243.

1247 See SIFMA (September 2015), supra note 5.

report. The Commission believes it is important for the board, the audit committee and the senior officer to all have the opportunity to receive the compliance report so that they remain informed regarding the SBS Entity's compliance system in the context of their overall responsibility for governance and internal controls of the SBS Entity. However, the Commission declines to explicitly require the board to review and comment on the compliance report, require the audit committee to review the compliance report, or require the CCO to meet quarterly with the audit committee, as suggested by other commenters.[1248] The Commission does not think it is necessary to explicitly require the board, audit committee or senior officer to review or comment on the compliance report that they receive, or to require the CCO to meet with the audit committee because we believe the goals of the rule can be achieved without such a requirement.

Additionally, in response to concerns raised by a commenter[1249] and to harmonize with the parallel CFTC requirement and FINRA Rule 3130, the Commission is eliminating: (1) the proposed requirement that the report contain a written representation regarding the required annual meeting between the senior officer and the CCO, and (2) the proposed specifications for what topics such meeting must cover. The Commission agrees with the commenter that since the purpose of the required annual meeting between the senior officer and CCO is to discuss the annual compliance report and since the contents of the annual compliance report are already specified in Rule 15Fk-1(c)(2)(i), it is unnecessary to also specify the topics that should be discussed in the annual meeting.

1248 See Better Markets (August 2011), supra note 5; Better Markets (October 2013), supra note 5; CFA, supra note 5.

1249 See SIFMA (September 2015), supra note 5.

Additionally, this consistency with CFTC and FINRA requirements will allow SBS Entities to leverage any existing procedures, as discussed above.

To address concerns raised by commenters,[1250] we also are modifying Rule15Fk-1(c)(2)(ii)(D) to provide that either the senior officer or CCO can execute the compliance report certification and to add knowledge and materiality qualifiers to the certification requirement. The proposed rule would have required the compliance report to include a certification that, under penalty of law, the compliance report is accurate and complete, without specifying who must execute the certification. As adopted, Rule 15Fk-1(c)(2)(ii)(D) requires the compliance report to include a certification "from the senior officer or Chief Compliance Officer that, to the best of his or her knowledge and reasonable belief, under penalty of law, the compliance report is accurate and complete in all material respects." The Commission believes that allowing either the senior officer or CCO to execute the certification is appropriate because both the senior officer and the CCO should be in a position to certify the accuracy and completeness of the compliance report. As noted by a commenter,[1251] Exchange Act Section 15F(k)(3)(B)(ii) requires that the compliance report include a certification but does not specify who must execute the certification.[1252] The FINRA rule regarding annual certification of compliance and

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1250 See FIA/ISDA/SIFMA, supra note 5 (requesting that the CEO or other relevant senior officer be the individual responsible for executing the certification, or in the alternative, if the CCO is required to certify, that the CEO also be required to do so); CFA, supra note 5 (requesting that the CCO be the individual responsible for executing the certification); SIFMA (September 2015), supra note 5 (requesting that either the senior officer or CCO be permitted to execute the certification).

1251 See FIA/ISDA/SIFMA, supra note 5.

1252 See Section 15F(k)(3)(B)(ii) of the Exchange Act, 15 U.S.C. 78o-10(k)(3)(B)(ii).

supervisory processes requires the CEO (or an equivalent officer) to execute the certification.[1253] In contrast, Commission rules regarding compliance reports by SDRs require the CCO to execute the certification.[1254] CFTC rules regarding compliance reports by Swap Entities allow either the CEO or the CCO to execute the required certification.[1255] Rule 15Fk-1(c)(2)(ii)(D) will be consistent with the parallel CFTC rule and will allow flexibility for SBS Entities who might also be registered broker-dealers and FINRA members, and therefore, subject to the FINRA rule regarding annual certification of compliance and supervisory processes. As discussed above, consistency with CFTC requirements will allow SBS Entities to leverage any existing procedures.

Additionally, the Commission believes it is appropriate to add the knowledge and materiality qualifiers described above to the required certification to address commenters' concerns regarding the liability standard for the certification.[1256] The Commission believes that a certification to the best of the knowledge and reasonable belief of the certifying officer that the compliance report is accurate and complete in all material respects is appropriate to ensure effective reporting with respect to the compliance of the SBS Entity.[1257]

1253 See FINRA Rule 3130(c).

1254 See SDR Registration Release, 80 FR at 14511-14512, supra note 1202.

1255 See CFTC CCO Adopting Release, 77 FR at 20201, supra note 1243.

1256 See FIA/ISDA/SIFMA, supra note 5; SIFMA (September 2015), supra note 5. Contra. CFA, supra note 5 (arguing that the CCO should not be permitted to qualify its report).

1257 Cf. General Rule of Practice 153(b)(1)(ii), 17 CFR 201.153(b)(1)(ii) (requiring an attorney who signs a filing with the Commission to certify that "to the best of his or her knowledge, information, and belief, formed after reasonable inquiry, the filing is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law").

In response to a specific suggestion from a commenter,[1258] the Commission is also adding a new Rule 15Fk-1(c)(2)(iv) allowing an SBS Entity to incorporate by reference sections of a compliance report that have been submitted within the current or immediately preceding reporting period to the Commission. The rule allows an SBS Entity to: (1) incorporate by reference items from a previous year's compliance report, or (2) for an SBS Entity that is registered in more than one capacity with the Commission and required to submit more than one compliance report,[1259] incorporate by reference into its compliance report required by Rule 15Fk-1(c) sections in another compliance report submitted to the Commission by it in its capacity as another type of registered entity within the current or immediately preceding reporting period.[1260] The Commission is limiting incorporation by reference to reports submitted within the current or immediately preceding reporting period, which will be the fiscal year of the SBS Entity, because we want to ensure that compliance reports do not simply continue to refer back to prior year's reports. Rule 15Fk-1(c)(2)(iv) will also be consistent with CFTC rules regarding compliance reports by Swap Entities.[1261]

1258 See SIFMA (September 2015), supra note 5.

1259 See SDR Registration Release, 80 FR at 14510-14512, supra note 1202.

1260 The Commission declines to permit the consolidation of annual compliance reporting requirements for SBS Entities under common control, as suggested by one commenter. See FIA/ISDA/SIFMA, supra note 5. The Commission believes it is appropriate to require an SBS Entity to submit a separate compliance report, as contemplated by Section 15F(k)(3)(B) of the Exchange Act. However, as discussed above, the Commission has made a number of changes to Rule 15Fk-1 to further harmonize the requirements of the rule with FINRA Rule 3130 and the CFTC's CCO requirements for Swap Entities so that SBS Entities that are also registered broker-dealers that are FINRA members and/or Swap Entities can leverage their existing procedures to comply with the rule.

1261 See CFTC CCO Adopting Release, 77 FR at 20201, supra note 1243.

Finally, in response to a specific suggestion from a commenter,[1262] the Commission is adding a new Rule 15Fk-1(c)(2)(v) requiring an SBS Entity to submit an amended compliance report if material errors or omissions in the report are identified. The amended report must contain the required certification by the CCO or senior officer, described above. The Commission is adding this rule to promote accurate and complete compliance reports. When an SBS Entity discovers a material error or omission in its annual compliance report subsequent to submitting the report to the Commission, we believe it is appropriate for an SBS Entity to be required to submit an amended report. This does not include a situation where an SBS Entity's annual compliance report becomes inaccurate or incomplete due to events occurring after the coverage date of the report. Material errors or omissions should be judged as of the coverage date of the report. Rule 15Fk-1(c)(2)(v) will also be consistent with CFTC rules regarding amended compliance reports by Swap Entities.[1263]

J. Prime Brokerage Transactions

One commenter recommended that the Commission adopt a new rule that would, in connection with security-based swaps executed under a prime brokerage arrangement, permit the executing dealer and prime broker to allocate responsibility for compliance with certain external business conduct obligations in a manner consistent with CFTC No-Action Letter 13-11.[1264] The commenter noted that the Commission staff has previously addressed circumstances in which the executing broker and prime broker in a securities

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1262 See SIFMA (September 2015), supra note 5.

1263 See CFTC CCO Adopting Release, 77 FR at 20201, supra note 1243.

1264 See SIFMA (August 2015), supra note 5.

prime brokerage arrangement allocate certain responsibilities between themselves in different contexts.[1265]

The commenter described a particular situation in which a counterparty ("Prime Broker Client") enters into an agreement with a registered SBS Dealer ("Prime Broker"). That agreement establishes parameters under which the Prime Broker Client, acting as agent of the Prime Broker, can negotiate and enter into security-based swaps with certain registered SBS Dealers (collectively, the "Executing Dealer"). If a security-based swap negotiated by the Prime Broker Client with the Executing Dealer is accepted by the Prime Broker, the Prime Broker will enter into a corresponding security-based swap with the Prime Broker Client, the terms of which mirror the terms of the security-based swap between the Executing Dealer and the Prime Broker, subject to associated prime brokerage fees agreed by the parties.

In these circumstances, the Prime Broker Client may have entered into a security-based swap with the Prime Broker based not only on communications with the Prime Broker but also on communications including disclosure of material terms and other representations, and possibly on the basis of a recommendation by the Executing Dealer. According to this commenter, in these circumstances, the Prime Broker is in the best position to take responsibility for compliance with the external business conduct standards that relate to the general relationship between the Prime Broker and the Prime Broker Client, whereas the Executing Dealer is in the best position to take responsibility for compliance with business conduct standards that are transaction-specific. The

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[1265] See Letter to Mr. Jeffrey C. Bernstein, Prime Broker Committee, from Brandon Becker, Director, Division of Market Regulation, Commission, dated January 25, 1994.

commenter expressed the view that unless SBS Dealers are permitted to allocate compliance with the external business conduct standards between the Prime Broker and the Executing Dealer, it would be impossible to continue existing prime brokerage arrangements.[1266]

The commenter proposed a rule under which the Prime Broker and the Executing Dealer would have the full range of business conduct obligations that they would allocate between themselves. The commenter's request is beyond the scope of this rulemaking although we acknowledge the concerns raised by the commenter, and may consider them in the future.

K. Other Comments

The CFTC proposed rules regarding best execution and front running that it did not ultimately adopt. One commenter urged the Commission to adopt a best execution requirement similar to the CFTC's proposal.[1267] Another commenter urged the Commission not to adopt a prohibition on front running.[1268] Although the Commission is not adopting such rules, we note that SBS Entities remain subject to the antifraud provisions of the federal securities laws, including the antifraud provisions of Exchange Act Section 15H(h)(4)(A) and Rule 15Fh-4(a), as discussed in Section II.H.4, with respect to their dealings with counterparties.

1266 We recognize that there may be other ways that parties structure their prime brokerage arrangements. The above discussion is based on the description of the arrangement in the proposed rule text provided by the commenter.

1267 See CFA, supra note 5.

1268 See SIFMA (August 2011), supra note 5. Front running refers to an entity entering into a transaction for its own benefit ahead of executing a counterparty transaction.

The Commission did not propose rules regarding portfolio reconciliation and compression. Four commenters generally supported portfolio reconciliation and compression requirements.[1269] A fifth commenter asserted that inter-affiliate swaps should not trigger portfolio reconciliation and compression requirements.[1270] The Commission is not adopting rules regarding portfolio reconciliation and compression at this time.

III. Cross-Border Application and Availability of Substituted Compliance

A. Cross-Border Application of Business Conduct Requirements

1. Proposed Rule

The Commission proposed generally to apply all requirements in Section 15F of the Exchange Act, and the rules and regulations thereunder, to all SBS Entities, whether U.S. persons or non-U.S. persons.[1271] The Commission also proposed to classify each requirement that applies to SBS Entities either as a transaction-level requirement, which applies to specific transactions, or as an entity-level requirement, which applies to the dealing entity as a whole.[1272] In this taxonomy, entity-level requirements would include most requirements applicable to SBS Entities, including those relating to the CCO requirements under Section 15F(k) of the Exchange Act, the supervision requirement under Section 15F(h)(1)(B) of the Exchange Act, and the requirement to establish

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1269 See Barnard, supra note 5; Levin, supra note 5; Markit, supra note 5; MarkitSERV, supra note 5.

1270 See ABA Securities Association, supra note 5.

1271 See Cross-Border Proposing Release, 78 FR 31009, 31035, supra note 6. The Commission noted in the Cross-Border Proposing Release its longstanding "view that an entity that has registered with the Commission subjects itself to the entire regulatory system governing such registered entities." Id. at 30986.

1272 See Cross-Border Proposing Release, 78 FR 31009, 31035, supra note 6.

procedures to comply with the duties set forth in Section 15F(j) of the Exchange Act, including conflict of interest systems and procedures.[1273] Transaction-level requirements would include primarily business conduct standards under Section 15F(h) of the Exchange Act (except for the diligent supervision requirement under Section 15F(h)(1)(B) of the Exchange Act).[1274]

Under the proposed approach, the entity-level requirements would apply to all transactions of an SBS Entity, regardless of the U.S.-person status of the SBS Entity or its counterparty to any particular transaction.[1275] With respect to the business conduct standards under Section 15F(h) of the Exchange Act (except for the diligent supervision requirement under Section 15F(h)(1)(B) of the Exchange Act), however, the Commission proposed to provide an exception from these requirements for certain transactions of SBS Entities, proposing slightly different approaches for SBS Dealers and Major SBS Participants.

With respect to SBS Dealers, the Commission proposed a rule that would have provided that registered foreign SBS Dealers and registered U.S. SBS Dealers, with respect to their foreign business, would not be subject to the requirements relating to business conduct standards described in Section 15F(h) of the Exchange Act,[1276] and the rules and regulations thereunder, other than the rules and regulations prescribed by the

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1273 See Cross-Border Proposing Release, 78 FR 31014-15, 31035, supra note 6.

1274 See Cross-Border Proposing Release, 78 FR 31010, 31035, supra note 6. See also U.S. Activity Proposing Release, 80 FR 27473, supra note 9.

1275 See Cross-Border Proposing Release, 78 FR 31026-27, 31035, supra note 6.

1276 15 U.S.C. 78o-10(h). See proposed Rule 3a71-3(c) (providing a partial exception from certain transaction-level business conduct standards for foreign SBS Dealers in connection with their foreign business); see also Cross-Border Proposing Release, 78 FR 31016-18, supra note 6.

Commission pursuant to Section 15F(h)(1)(B).[1277] The proposed rule would define "foreign business" for both foreign SBS Dealers and U.S. SBS Dealers to mean any security-based swap transactions entered into, or offered to be entered into, by or on behalf of the SBS Dealer that do not include its U.S. business.[1278] The proposed definition of "U.S. business," however, would differ for foreign SBS Dealers and U.S. SBS Dealers. For a foreign SBS Dealer, "U.S. business" would mean (i) any transaction entered into, or offered to be entered into, by or on behalf of such foreign SBS Dealer, with a U.S. person (other than with a foreign branch), or (ii) any transaction conducted within the United States.[1279] For a U.S. SBS Dealer, "U.S. business" would mean any transaction by or on behalf of such U.S. SBS Dealer, wherever entered into or offered to be entered into, other than a transaction conducted through a foreign branch with a non-U.S. person or another foreign branch of a U.S. person.[1280]

In April 2015, the Commission re-proposed the rule defining the application of business conduct rules to SBS Dealers to incorporate the modified approach to U.S. activity proposed in that release and to make certain technical changes to the "foreign

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1277 See Cross-Border Proposing Release, 78 FR 31016, supra note 6. Section 15F(h)(1)(B) requires registered SBS Dealers to conform with such business conduct standards relating to diligent supervision as the Commission shall prescribe. See 15 U.S.C. 78o-10(h)(1)(B).

1278 See Cross-Border Proposing Release, 78 FR 31016, supra note 6.

1279 See Cross-Border Proposing Release, 78 FR 31016, supra note 6. Whether the activity in a transaction involving a registered foreign SBS Dealer occurred within the United States or with a U.S. person for purposes of identifying whether security-based swap transactions are part of U.S. business would have turned on the same factors used in that proposal to determine whether a foreign SBS Dealer is engaging in dealing activity within the United States or with U.S. persons and whether a U.S. person was conducting a transaction through a foreign branch. See Cross-Border Proposing Release, 78 FR 31016, supra note 6.

1280 See Cross-Border Proposing Release, 78 FR 31016, supra note 6.

business" definition relating to transactions conducted through a foreign branch.[1281] Under the modified approach, "U.S. business" of a foreign SBS Dealer would have been defined to mean (i) any transaction entered into, or offered to be entered into, by or on behalf of such foreign SBS Dealer, with a U.S. person (other than a transaction conducted through a foreign branch of that person), or (ii) any security-based swap transaction that is arranged, negotiated, or executed by personnel of the foreign SBS Dealer located in a U.S. branch or office, or by personnel of its agent located in a U.S. branch or office.[1282] With respect to a U.S. SBS Dealer, "U.S. business" would have been defined to mean "any transaction by or on behalf of such U.S. SBS Dealer, entered into or offered to be entered into, other than a transaction conducted through a foreign branch with a non-U.S. person or with a U.S.-person counterparty that constitutes a transaction conducted through a foreign branch of the counterparty."[1283] The definitions of "U.S. security-based swap dealer,"[1284] "foreign security-based swap dealer,"[1285] and "foreign business"[1286]

1281 U.S. Activity Proposing Release, 80 FR 27475, supra note 9. See also proposed Rule 3a71-3(c) and proposed Rules 3a71-3(a)(6), (7), (8), and (9).

1282 Proposed Rule 3a71-3(a)(8)(i). The Commission explained in the U.S. Activity Proposing Release that it intended the proposed rule to indicate the same type of activity by personnel located in the United States as it proposed to use in the de minimis context. Moreover, for purposes of proposed Rule 3a71-3(a)(8)(i)(B), the Commission explained that it would interpret the term "personnel" in a manner consistent with the definition of "associated person of a security-based swap dealer" contained in section 3(a)(70) of the Exchange Act, 15 U.S.C. 78c(a)(70), regardless of whether such non-U.S. person or such non-U.S. person's agent is itself a security-based swap dealer. See U.S. Activity Proposing Release 80 FR at 27469 n.193, supra note 9.

1283 Proposed Rule 3a71-3(a)(8)(ii).

1284 See proposed Rule 3a71-3(a)(6).

1285 See proposed Rule 3a71-3(a)(7).

1286 See proposed Rule 3a71-3(a)(9).

remained unchanged from the initial proposal, as did the text of re-proposed Rule 3a71-3(c), which would create the exception to the business conduct requirements for the foreign business of registered security-based swap dealers.

With respect to Major SBS Participants, the Commission proposed to provide an exception from the business conduct standards as described in Section 15F(h) of the Exchange Act, and the rules and regulations thereunder (other than the rules and regulations prescribed by the Commission pursuant to Section 15F(h)(1)(B)), only for foreign Major SBS Participants, with respect to their transactions with non-U.S. persons.[1287]

2. Comments on the Proposed Application of Business Conduct Requirements to SBS Entities

In response to the U.S. Activity Proposing Release, commenters focused on the proposal to impose business conduct standards on a transaction of a registered foreign SBS Dealer with other non-U.S. persons when the SBS Dealer uses personnel located in the United States to arrange, negotiate, or execute the transaction. Several commenters expressed general support for the Commission's proposed test to determine when various Title VII requirements should apply to transactions between two non-U.S. persons based on U.S. activity.[1288] Moreover, although these commenters generally urged that the Commission not impose business conduct requirements (or impose only certain of the

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1287 See proposed Rule 3a67-10(b) (providing that a Major SBS Participant "shall not be subject, with respect to its security-based swap transactions with counterparties that are not U.S. persons, to the requirements relating to business conduct standards" in Section 15F(h) of the Exchange Act and the rules and regulations thereunder, other than rules and regulations prescribed pursuant to Section 15F(h)(1)(B) of the Exchange Act); proposed Rule 3a67-10(a)(1) (defining "foreign major security-based swap participant").

1288 See, e.g., SIFMA/FSR (July 2015), supra note 10; IIB (July 2015), supra note 10.

requirements, as described below) on a registered foreign SBS Dealer solely based on U.S. activity, they indicated that they support the tailoring of the Commission's test ("U.S. Activity Test") from the initial proposal, if the Commission ultimately determines that the business conduct requirements should apply to such transactions.[1289] One commenter urged the Commission to return to its initially proposed approach to the definition of "transactions conducted within the United States," which would have looked to the location of relevant activity of both counterparties.[1290] Such an approach would thus apply the business conduct requirements fully to any transactions involving activity in the United States, not just dealing activity in the United States but also relevant activity carried out by a non-dealing counterparty in the United States.[1291]

Some commenters that objected to the Commission's proposed approach argued that none of the business conduct requirements should apply to transactions between non-U.S. persons, even if these transactions involve U.S. activity and therefore constitute "U.S. business" under the proposed definition.[1292] These commenters explained that the

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1289 See IIB (July 2015), supra note 10, at 2; SIFMA/FSR (July 2015), supra note 10, at 3, 10. One commenter supported the proposal's use of the same U.S. Activity Test for business conduct as for de minimis calculations because applying the business conduct standards solely based on the use of a U.S. fund manager is not dealing activity, would be inconsistent with investor expectations, and is unnecessary to protect the U.S. markets. See ICI Global (July 2015), supra note 10, at 2, 5.

1290 See Better Markets (July 2015), supra note 10, at 3, 6.

1291 See id.

1292 See ICI Global (July 2015), supra note 10, at 2, 5-6; SIFMA-AMG (July 2015), supra note 10, at 2, 5 (stating that non-U.S. clients do not expect U.S. protections to apply to transactions between two non-U.S. persons). See also ISDA (July 2015), supra note 10, at 2 (urging that the Commission not apply the business conduct requirements to transactions solely because the transaction involves U.S. activity); ISDA (July 2015), supra note 10, at 8 (arguing that the Commission

non-U.S. counterparties of foreign SBS Dealers do not expect these protections; the dealer is likely to be subject to similar requirements in its home jurisdiction; and application is unlikely to protect the U.S. market and is inconsistent with international comity.[1293] In a related comment, one commenter explained that the business conduct requirements, as well as other requirements related to reporting and dealer registration, should not apply to transactions that are executed on an anonymous electronic platform or other means that "involve[s] no human contact within the United States," because the parties would have no expectation that the rules would apply to such a transaction.[1294]

Some commenters taking this view also explained that U.S. asset managers may face challenges in servicing non-U.S. client accounts under the proposed approach, noting that non-U.S. clients may be reluctant to deal with Dodd-Frank-related documentation or to make required representations and describing the significant burdens these requirements would impose on asset managers.[1295] One of these commenters

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does not have a supervisory interest in imposing entity-level requirements in connection with security-based swap transactions between two non-U.S. persons that are cleared outside the United States, even if they are arranged, negotiated, or executed by personnel located in the United States).

1293 See ICI Global (July 2015), supra note 10, at 5-6; SIFMA-AMG (July 2015), supra note 10, at 2, 5; IIB (July 2015), supra note 10, at 11; SIFMA/FSR (July 2015), supra note 10, at 9. See also ISDA (July 2015), supra note 10, at 2, n.7 (recommending that the final business conduct rules be consistent with the CFTC's business conduct rules); Barnard (July 2015) at 2, supra note 10 (recommending that the rules proposed in the U.S. Activity Proposing Release be consistent with the rules proposed by the CFTC); MFA (July 2015), supra note 10, at 4 (emphasizing need for Commission and its U.S. counterparts to develop a single, harmonized approach to cross-border derivatives regulation).

1294 See ISDA (July 2015), supra note 10, at 7.

1295 Specifically, the commenters expressed concern that, under the proposal, the U.S. asset manager executing a trade on behalf of a non-U.S. client would need to know whether the transaction involved U.S. activity and would also need to verify

argued that the U.S. Activity Proposing Release considered only the costs of the SBS Dealers that would be directly subject to the business conduct requirements but not the costs borne by buy-side market participants, such as asset managers.[1296]

Some commenters that objected to the Commission's proposed application of business conduct requirements to transactions between two non-U.S. persons solely on the basis of activity in the United States urged the Commission to limit the application to specific requirements that, in the commenters' views, address regulatory concerns directly related to the relevant activity in the United States. These commenters supported dividing the business conduct requirements into two separate categories of "relationship-based" requirements and "transaction-specific" or "communication-based" requirements.[1297] Commenters argued that relationship-based requirements—which they identified as requirements related to counterparty status, disclosure of daily marks, know your counterparty, and counterparty suitability—should not apply to transactions between

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that the non-U.S. client satisfies the business conduct requirements. See SIFMA-AMG (July 2015), supra note 10, at 4; ICI Global (July 2015), supra note 10, at 6 (explaining that regulated fund parties would need appropriate documentation and representations in place to execute such trades and would face interruptions in investment activities in doing so).

1296 See SIFMA-AMG (July 2015), supra note 10, at 4-5. This commenter specifically argued that the proposed rules would effectively require asset managers to verify the eligibility of a non-U.S. client as having satisfied the Commission's business conduct requirements, imposing costs on asset managers and, through impeding block trades on behalf of U.S. persons and non-U.S. persons, negatively affecting liquidity and execution price. See SIFMA-AMG (July 2015), supra note 10, at 4. The commenter also argued that the proposed approach has "no ascertainable benefit" to non-U.S. counterparties who would not expect the protections and would instead look to the law of the dealer's jurisdiction or its own jurisdiction. See SIFMA-AMG (July 2015), supra note 10, at 5.

1297 See SIFMA/FSR (July 2015), supra note 10, at 8-10; IIB (July 2015), supra note 10, at 11-13.

two non-U.S. persons solely on the basis of U.S. activity for reasons similar to those described above.[1298]

On the other hand, commenters explained that application of business conduct requirements that are "communication-based" or transaction-specific—which they identified as including disclosure of material risks and characteristics and material incentives or conflicts of interest and related recordkeeping, disclosures regarding clearing rights and related recordkeeping, product suitability, and fair and balanced communications and supervision—to such transactions would be simpler and less costly to implement.[1299] These commenters, however, urged the Commission, if it does apply

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1298 For example, one commenter argued that non-U.S. counterparties would not expect such protections and that the requirements may duplicate requirements in the counterparty's home jurisdiction. See SIFMA/FSR (July 2015), supra note 10, at 8-9. Commenters also argued that the non-U.S. counterparty would not expect to provide any representations as to its status or to complete questionnaires to comply with U.S. relationship-level requirements, particularly at the beginning of a trading relationship when neither counterparty may expect the relationship to involve U.S. activity and that such burdens have no benefit. See SIFMA/FSR (July 2015), supra note 10, at 8-9; IIB (July 2015), supra note 10, at 11-12 (arguing that non-U.S. counterparties would not expect the "trade-relationship" requirements to apply in their trades with non-U.S. persons and would be surprised to be required to agree to covenants or fill out questionnaires related to U.S. requirements); SIFMA-AMG (July 2015), supra note 10, at 4 (explaining that non-U.S. clients of asset managers would be surprised to need to verify eligibility under the business conduct requirements after instructing asset managers to trade only with non-U.S. dealers). See also ICI Global (July 2015), supra note 10, at 6 (noting that, even though the registered dealer (and not the non-U.S. person) is subject to the business conduct requirements, the non-U.S. fund counterparty would likely need to have in place appropriate documentation and representations if its dealer is subject to business conduct requirements, which may cause interruptions in their investment activities).

1299 See IIB (July 2015), supra note 10, at 12-13 (noting that compliance with these requirements would not require "wholesale modifications" to the relationship documentation or onboarding processes as long as the non-U.S. security-based swap dealer is able to satisfy the requirements under the rules of the relevant non-U.S. jurisdictions and that there may be benefits to applying these rules uniformly

the transaction-specific requirements to these transactions, to harmonize FINRA's existing sales practice requirements with the "communication-based" or transaction-specific rules applicable under Title VII to avoid unnecessary duplication or conflicts, as the U.S. activity in many of these transactions may be carried out by registered broker-dealers subject to FINRA requirements.[1300] One commenter requested that if the Commission does apply relationship-based requirements to transactions involving U.S. activity, it make substituted compliance available to foreign registered SBS Dealers in such transactions.[1301]

Two commenters suggested that, if the Commission does apply the business conduct requirements as proposed, it offer an "opt-out" for sophisticated non-U.S. person counterparties that would allow them to trade under their existing documentation rather than develop new documentation pursuant to U.S. rules.[1302] One commenter explained

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to front office personnel in the United States as a supplement to generally applicable antifraud and anti-manipulation rules); SIFMA/FSR (July 2015), supra note 10, at 9-10 (explaining that the application of these rules would be consistent with the parties' expectations).

1300 See SIFMA/FSR (July 2015), supra note 10, at 9-10; IIB (July 2015), supra note 10, at 13. Commenters also urged the Commission to work toward a harmonized approach to all the business conduct rules with the CFTC and FINRA to ensure that security-based swap dealers and swap dealers are not subject to two different sets of business conduct requirements. See ISDA (July 2015), supra note 10, at 2, n.7; IIB (July 2015), supra note 10, at 6, 7. See also ISDA (July 2015), supra note 10, at 9 (asking the Commission to evaluate whether imposing business conduct requirements adds value if the intermediary is already subject to broker-dealer regime).

1301 See IIB (July 2015), supra note 10, at 12.

1302 See IIB (July 2015), supra note 10, at 13; SIFMA/FSR (July 2015), supra note 10, at 10-11 (requesting the non-U.S. counterparty have option to opt-out of "transaction-specific" rules if they apply solely as a result of U.S. activity).

that, because the requirements are for the benefit of the non-U.S. counterparty, that counterparty should be able to waive them.[1303]

Two commenters argued that the Commission should not allow concern about special entity protections to influence its consideration of whether U.S. activity alone should trigger business conduct requirements. These commenters noted that the Commission has previously explained that only U.S. persons would be special entities and, as such, a registered foreign SBS Dealer would already be subject to the full range of business conduct requirements in transactions with special entities, because such transactions would constitute "U.S. business" under the proposed approach even if the Commission were to eliminate U.S. Activity from the definition of "U.S. business."[1304]

3. Response to Comments and Final Rule

After considering the comments, the Commission is adopting final Rule 3a71-3(c) and amendments to the definitions in Rule 3a71-3(a) largely unchanged from the April 2015 re-proposal.[1305] The Commission is also adopting amendments to Rule 3a67-10 to incorporate an exception from these requirements for registered Major SBS Participants, modified slightly from the initial proposal. Consistent with the Cross-Border Proposing

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1303 See SIFMA/FSR (July 2015), supra note 10, at 10-11.

1304 See IIB (July 2015), supra note 10, at 12; SIFMA/FSR (July 2015), supra note 10, at 9.

1305 The final rules incorporate minor conforming edits. The definition of U.S. business for U.S. security-based swap dealers (Rule 3a71-3(a)(8)(ii)) is modified for consistency with the surrounding rules by moving the phrase "entered into or offered to be entered into" and deleting the word "wherever" to further clarify that the definition of U.S. business for a U.S. security-based swap dealer does not depend on the location of personnel arranging, negotiating, or executing the transaction. Rule 3a71-3(a)(9) defining foreign business and Rule 3a71-3(c) contain minor edits to simplify the rule text primarily by eliminating unnecessary separate references to U.S. and foreign security-based swap dealers.

Release, the Commission is not providing any exception from the entity-level requirements being adopted in this release.[1306]

a. Entity-Level Requirements for SBS Entities

The Commission continues to believe that the rules and regulations prescribed by the Commission relating to diligent supervision pursuant to Section 15F(h)(1)(B), those relating to the CCO under Section 15F(k) of the Exchange Act, and those relating to requirements under Section 15F(j) of the Exchange Act should be treated as entity-level requirements that apply to the entire business of the registered foreign or U.S. SBS Entity.[1307] Accordingly, the following requirements would apply to all security-based

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1306 The Commission does not believe that these final rules apply Title VII to persons that are "transact[ing] a business in security-based swaps without the jurisdiction of the United States," within the meaning of section 30(c) of the Exchange Act. A final rule that did not treat security-based swaps that a registered foreign security-based swap dealer has arranged, negotiated, or executed using its personnel or personnel of its agent located in the United States as the "U.S. business" of that dealer for purposes of proposed Exchange Act rule 3a71–3(c) would, in our view, reflect an understanding of what it means to conduct a security-based swap dealing business within the jurisdiction of the United States that is divorced both from Title VII's statutory objectives and from the various structures that non-U.S. persons use to engage in security-based swap dealing activity. But in any event we also believe that the final rule is necessary or appropriate as a prophylactic measure to help prevent the evasion of the provisions of the Exchange Act that were added by the Dodd-Frank Act, and thus help prevent the relevant purposes of the Dodd-Frank Act from being undermined. See Cross-Border Adopting Release, 79 FR 47291–92, supra note 193 (interpreting anti-evasion provisions of Exchange Act Section 30(c)). Without this rule, non-U.S. persons could simply carry on a dealing business within the United States with non-U.S. persons. Permitting this activity could allow these firms to retain full access to the benefits of operating in the United States while avoiding compliance with business conduct requirements, which could increase the risk of misconduct. See U.S. Activity Proposing Release, 80 FR 27477 n.255, supra note 9.

1307 See Cross-Border Proposing Release, 78 FR 31013-15, supra note 6 (classifying these requirements, among others, as entity-level). But see ISDA (July 2015), supra note 10, at 8 (arguing that the Commission does not have a supervisory

swap transactions of an SBS Entity, regardless of the U.S.-person status of the SBS Entity or that of its counterparty in any particular transaction:[1308] supervision requirements under Rule 15Fh-3(h), including the requirement in Rule 15Fh-3(h)(2)(iii)(I) that SBS Entities establish procedures reasonably designed to comply with the duties set forth in Section 15F(j) of the Exchange Act; and CCO requirements under Rule 15Fk-1. The Commission, however, is adopting a rule that would potentially make substituted compliance available for these requirements for registered foreign SBS Entities as discussed below.[1309]

As the Commission has previously stated, it is appropriate to subject a registered SBS Entity to the diligent supervision requirements regardless of the status or location of its counterparties to ensure that the SBS Entity is adequately supervising its business and its associated persons to ensure compliance with the full range of its obligations under the federal securities laws.[1310] Similarly, the Commission continues to believe that Rule 15Fh-3(h)(2)(iii)(I), which requires SBS Entities to establish procedures to comply with the duties set forth in Section 15F(j) of the Exchange Act, including conflict of interest systems and procedures, should apply to all of an SBS Entity's security-based swap transactions, as such systems and procedures cannot be effective unless so applied.[1311]

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interest in imposing entity-level requirements in connection with security-based swap transactions between two non-U.S. persons that are cleared outside the United States, even if they are arranged, negotiated, or executed by personnel located in the United States).

1308 See Cross-Border Proposing Release, 78 FR 31026-27, 31035, supra note 6.

1309 See Section III.B, infra.

1310 See Cross-Border Proposing Release, 78 FR 31014, 31017, supra note 6.

1311 See Cross-Border Proposing Release, 78 FR 31013-14, supra note 6.

As we have previously noted, to prevent conflicts of interest from biasing the judgment or supervision of these entities, application to only a portion of an SBS Entity's security-based swap transactions would not be effective at addressing conflicts that may arise as a result of transactions that arise out of an SBS Entity's foreign business.[1312] Each of the remaining duties under section 15F(j)[1313] would not be effective if not applied at the entity level.[1314]

The CCO requirements under Rule 15Fk-1 also raise entity-wide concerns. CCO's responsibilities include establishing, maintaining, and reviewing policies and procedures reasonably designed to ensure compliance with applicable Exchange Act requirements.[1315] Because such responsibilities apply to the entity as a whole and many of the requirements that the CCO oversees are entity-level requirements, the Commission

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1312 See Cross-Border Proposing Release, 78 FR 31014, supra note 6.

1313 Section 15F(j) of the Exchange Act requires an SBS Entity to comply "at all times" 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; 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. See 15 U.S.C. 78o-10(j).

1314 See Cross-Border Proposing Release, 78 FR 31014, supra note 6 (explaining that the purpose of the diligent supervision requirements is to prevent violations of applicable federal securities laws, and the rules and regulations thereunder, relating to an entity's entire business as a security-based swap dealer, which is not limited to either its foreign business or its U.S. business, but rather is comprised of its entire global security-based swap dealing activity, and as such, to be effective, the requirements should apply at the entity level).

1315 See Section II.I, supra.

believes that it is necessary to treat the CCO requirement as an entity-level requirement applicable to all of an SBS Entity's security-based swap business.[1316]

b. Transaction-Level Requirements for SBS Dealers

As noted above, the Commission is adopting final Rule 3a71-3(c) and amendments to the definitions in Rule 3a71-3(a) largely unchanged from the proposal. Accordingly, the final rule provides that registered SBS Dealers, with respect to their foreign business, shall not be subject to the requirements relating to business conduct standards described in Section 15F(h) of the Exchange Act,[1317] and the rules and regulations thereunder,[1318] other than the rules and regulations prescribed by the Commission pursuant to Section 15F(h)(1)(B).[1319] The final rule defines "foreign business" for both foreign SBS Dealers and U.S. SBS Dealers to mean any security-based

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1316 See Cross-Border Proposing Release, 78 FR 31014-15, supra note 6.

1317 15 U.S.C. 78o-10(h).

1318 These rules and regulations are Rules 15Fh-1 through 15Fh-6. With the exception of Rule 15Fh-3(h), which prescribes certain entity-level requirements pursuant to Exchange Act Section 15F(h)(1)(B), these rules are transaction-level requirements, which is consistent with the proposed approach. See, supra, Section III.0.

1319 See Rule 3a71-3(c).

Section 15F(h)(1)(B) requires registered security-based swap dealers to conform with such business conduct standards relating to diligent supervision as the Commission shall prescribe. See 15 U.S.C. 78o-10(h)(1)(B). The rules being prescribed pursuant to Exchange Act Section 15F(h)(1)(B) are those in Rule 15F-3(h), which are entity-level requirements, as discussed above. See, supra, Section III.0. The exception as adopted applies to Section 15F(h)(1)(A) of the Exchange Act, and any rules and regulations thereunder. However, this exception does not affect applicability of the general antifraud provisions of the federal securities laws to the activity of a foreign SBS Dealer. See Cross-Border Proposing Release, 78 FR 31016 n.476, supra note 6.

swap transactions entered into, or offered to be entered into, by or on behalf of the SBS Dealer that do not include its U.S. business.[1320]

However, the final rule defines "U.S. business" differently for foreign SBS Dealers and U.S. SBS Dealers. The final rule defines "U.S. business" of a foreign SBS Dealer to mean (i) any transaction entered into, or offered to be entered into, by or on behalf of such foreign SBS Dealer, with a U.S. person (other than a transaction conducted through a foreign branch of that person), or (ii) any security-based swap transaction that is arranged, negotiated, or executed by personnel of the foreign SBS Dealer located in a U.S. branch or office, or by personnel of its agent located in a U.S. branch or office.[1321] For a U.S. SBS Dealer, the final rule defines "U.S. business" to mean "any transaction entered into or offered to be entered into by or on behalf of such U.S. security-based swap dealer, other than a transaction conducted through a foreign branch with a non-U.S. person or with a U.S.-person counterparty that constitutes a transaction conducted through a foreign branch of the counterparty."[1322] The Commission also is adopting, unchanged from the proposals, the definitions of "U.S. security-based swap dealer,"[1323] and "foreign security-based swap dealer."[1324] The Commission also is adopting the definition of "foreign business,"[1325] with minor edits to simplify the rule text primarily by eliminating unnecessary separate references to foreign SBS Dealers and U.S. SBS

1320 See Rule 3a71-3(a)(9).

1321 See Rule 3a71-3(a)(8)(i).

1322 Rule 3a71-3(a)(8)(ii).

1323 See Rule 3a71-3(a)(6).

1324 See Rule 3a71-3(a)(7).

1325 See Rule 3a71-3(a)(9).

Dealers. Finally, the Commission is adopting Rule 3a71-3(c), which creates the exception from the application of the business conduct requirements to foreign business, again, unchanged from the proposal except for minor edits eliminating separate references to foreign SBS Dealers and U.S. SBS Dealers.

The final rule reflects the Commission's continuing view that all registered SBS Dealers should be required to comply with the transaction-level elements of the business conduct standards with respect to their U.S. business.[1326] The Dodd-Frank counterparty protection mandate focuses on the U.S. markets and participants in those markets.[1327] The business conduct standards are intended to bring professional standards of conduct to, and increase transparency in, the security-based swap market and to require registered SBS Dealers to treat parties to these transactions fairly.[1328] Accordingly, with respect to both foreign and U.S. SBS Dealers, we are adopting a definition of "U.S. business" that encompasses those transactions that appear particularly likely to affect the integrity of the security-based swap market in the United States and the U.S. financial markets more generally or that raise concerns about the protection of participants in those markets.

With respect to foreign SBS Dealers, the Commission continues to believe that the final definition of "U.S. business" should generally encompass transactions with U.S. persons and transactions that the foreign SBS Dealer arranges, negotiates, or executes

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1326 See U.S. Activity Proposing Release, 80 FR 27475, supra note 9.

1327 See Cross-Border Proposing Release, 78 FR 31017-018, supra note 6.

1328 See id. The rules require, among other things, that registered SBS Dealers communicate in a fair and balanced manner with potential counterparties and that they disclose conflicts of interest and material incentives to potential counterparties.

using personnel located in a U.S. branch or office.[1329] As we have previously noted, this approach would both preserve customer protections for U.S. counterparties that would expect to benefit from the protection afforded to them by Title VII of the Dodd-Frank Act and help maintain market integrity by subjecting the large number of transactions that involve relevant dealing activity in the United States to these requirements, even if both counterparties are non-U.S. persons.[1330]

With respect to U.S. SBS Dealers, the Commission continues to believe that the definition of "U.S. business" should encompass all of their transactions, regardless of the U.S.-person status of the counterparty, except for transactions that a U.S. SBS Dealer arranges, negotiates, or executes through a foreign branch with another foreign branch or with a non-U.S. person. As noted above, Title VII is concerned with the protection of U.S. markets and participants in those markets, and it remains our view that imposing these requirements on a U.S.-person dealer when it arranges, negotiates, or executes through its foreign branch with another foreign branch or a non-U.S. person would produce little or no benefit to U.S. market participants.[1331]

1329 We also note that relying on the same approach to U.S. activity that is used in the de minimis context should simplify implementation of Title VII for market participants. See U.S. Activity Proposing Release, 80 FR 27473, supra note 9.

1330 The exception from the definition for transactions involving the foreign branch of a U.S. person reflects our view that transactions between the foreign branch of a U.S. person and a non-U.S. person, in which the personnel arranging, negotiating, and executing the transaction are all located outside the United States, are less likely to affect the integrity of the U.S. market and reflects our consideration of the role of foreign regulators in non-U.S. markets. See Cross-Border Proposing Release, 78 FR 31017, supra note 6.

1331 See Cross-Border Proposing Release, 78 FR 31018, supra note 6.

One commenter urged the Commission to return to its initially proposed approach to the definition of "transactions conducted within the United States," which would have looked to the location of relevant activity of both counterparties.[1332] Such an approach would thus apply the business conduct requirements fully to any transactions involving activity in the United States, not just dealing activity in the United States but also relevant activity carried out by a non-dealing counterparty in the United States. Given the structure of the security-based swap market and the concentration of security-based swap dealing among a small group of firms, the Commission believes the final rules are appropriately tailored to apply the business conduct requirements to dealing activity, including dealing activity in the United States, that is likely to raise market integrity and transparency concerns.[1333] Further, as the Commission discussed in the U.S. Activity Adopting Release, the final rules adopted in that release should mitigate some commenters' concerns regarding the costs associated with the initially proposed application of the de minimis exception to "transactions conducted within the United States."[1334] The initially proposed approach supported by the commenter would have required a dealer engaged in dealing activity to consider both the location of its personnel and the personnel of its counterparty in determining whether to include transactions in its de minimis calculation thresholds.[1335] The final rules in the U.S. Activity Adopting Release and the final rule being adopted here focus on the location of relevant personnel

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1332 See note 1291, supra (citing Better Markets (July 2015), supra note 10).

1333 See U.S. Activity Adopting Release, 81 FR 8624, n.241 (explaining that the U.S. activity test is appropriately tailored to capture dealing activity that raises the types of concerns addressed by the Title VII dealer regime).

1334 See U.S. Activity Adopting Release, 81 FR 8627.

1335 See Cross-Border Proposing Release, 78 FR 31000-01, supra note 6.

of only the dealer (or its agent), which should impose lower costs on market participants than the initially proposed approach, while applying the business conduct requirements to dealing activity in the United States that is likely to raise the types of concerns addressed by the business conduct requirements.[1336] Moreover, given the Commission's action in the U.S. Activity Adopting Release, taking a different approach in the definition of "U.S. business" would mean using a different test to identify relevant U.S. activity from the test used in the de minimis context. The Commission believes that this would present unnecessary implementation and compliance challenges.[1337]

Some commenters have argued that the business conduct standards should not apply to any transactions between two non-U.S. persons because the foreign counterparties may not expect to receive such protections, or to any such transactions where expectations of receiving such protections are likely to be particularly low.[1338] The Commission has determined not to limit the application of the business conduct standards

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1336 See U.S. Activity Adopting Release, 81 FR 8627.

1337 See also U.S. Activity Proposing Release, 80 FR 27467, supra note 9 (discussing the change in approach in the context of the de minimis calculation from the Cross-Border Proposing Release, which proposed to focus both on the dealing and non-dealing counterparty, to the U.S. Activity Proposing Release, which proposed to focus only on the activity of personnel in the United States of the dealing counterparty).

1338 See ICI Global (July 2015), supra note 10, at 2, 5-6; SIFMA-AMG (July 2015), supra note 10, at 2, 5 (stating that non-U.S. clients do not expect U.S. protections to apply to transactions between two non-U.S. persons). See also ISDA (July 2015), supra note 10, at 2 (urging that the Commission not apply the business conduct requirements to transactions solely because the transaction involves U.S. activity); ISDA (July 2015), supra note 10, at 7 (arguing that business conduct requirement, as well as other requirements, should not apply to transactions that are executed on an anonymous electronic platform or other means that "involve[s] no human contact within the United States," because the parties would have no expectation that the rules would apply to such a transaction).

in this way. Counterparty expectations are not particularly relevant in determining whether a transaction that involves relevant activity in the United States has the potential to affect the integrity of the U.S. markets, particularly given that all of the registered foreign SBS Dealers subject to these requirements will have, by definition, a sufficient level of activity in the U.S. security-based swap market to exceed the de minimis threshold, many by an order of magnitude.[1339] Given the significant role registered SBS Dealers play in the market, applying the business conduct requirements to their U.S. business should help protect the integrity of the U.S. market.[1340]

Moreover, the approach to identifying relevant dealing activity in the United States reflects the Commission's determination that focusing solely on the location of the personnel arranging, negotiating, or executing the transaction on behalf of the foreign SBS Dealer appropriately balances the regulatory objectives of the business conduct standards with concerns about workability of an activity-based test. To create additional exceptions, particularly for activity occurring in the United States, based on the expectations of the non-dealing counterparty or the mode of its interaction with the foreign SBS Dealer would unnecessarily complicate this approach in a manner, as noted above, that would not advance the regulatory objectives served by these standards.[1341]

[1339] See U.S. Activity Adopting Release, 81 FR 8623 (rejecting commenter concerns that counterparties would not expect automated electronic trades to be subject to de minimis counting).

[1340] See U.S. Activity Adopting Release, 81 FR 8616 and n.166 (explaining that overwhelming majority of transactions captured by U.S. Activity Test are likely to be inter-dealer transactions carried out between non-U.S. persons whose dealing activity likely exceeds the de minimis threshold by at least an order of magnitude).

[1341] To the extent that anonymously executed transactions raise specific challenges or concerns, these are not unique to transactions between two non-U.S. persons

Some commenters have urged the Commission to harmonize any standards that the Commission does impose on these transactions with requirements that may separately apply to the foreign registered SBS Dealer's U.S.-person intermediary to avoid unnecessary duplication or conflicts.[1342] The Commission recognizes that business conduct standards could apply to transactions arising from relevant dealing activity in the United States, including Title VII and home jurisdiction requirements on the registered SBS Dealer and SRO requirements on the U.S. intermediary. As discussed above, the rules being adopted today are generally designed to be consistent with the relevant SRO requirements (and to harmonize with CFTC requirements), taking into account the nature of the security-based swap market and the statutory requirements for SBS Entities.[1343] The Commission does not believe that the commenters' concerns warrant a complete or partial exception from Title VII requirements for the registered SBS Dealer.

First, as discussed below, the Commission is adopting a rule that potentially would make substituted compliance available for the business conduct requirements following a substituted compliance determination by the Commission.[1344] Accordingly,

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involving relevant dealing activity in the United States. The Commission has separately addressed this issue above. See Section II.B, supra.

1342 Commenters urged the Commission to harmonize FINRA's existing sales practice requirements with the "communication-based" or transaction-specific rules applicable under Title VII. See SIFMA/FSR (July 2015), supra note 10, at 9-10; IIB (July 2015), supra note 10, at 13. Commenters also urged the Commission to work toward a harmonized approach to all the business conduct rules with the CFTC and FINRA to ensure that security-based swap dealers and swap dealers are not subject to two different sets of business conduct requirements. See also ISDA (July 2015), supra note 10, at 2, n.7; IIB (July 2015), supra note 10, at 6, 7.

1343 See Sections I.C and I.F, supra.

1344 See Rule 3a71-6. See also note 1301, supra (citing IIB (July 2015), supra note 10, at 12).

substituted compliance, if available, could mitigate the commenters' concerns regarding home country regulation.[1345] A person relying on substituted compliance would remain subject to the applicable Exchange Act requirements, but could comply with those requirements in an alternative fashion.[1346] In practice, however, we recognize that there will be limits to the availability of substituted compliance. For example, it is possible that substituted compliance may be permitted with regard to some requirements and not others with respect to a particular jurisdiction. For certain jurisdictions, moreover, substituted compliance may not be available with respect to any requirements depending on our assessment of the comparability of the relevant foreign requirements, as well as the availability of supervisory and enforcement arrangements among the Commission and relevant foreign financial regulatory authorities. Although comparability assessments will focus on regulatory outcomes rather than rule-by-rule comparisons, the assessments will require inquiry regarding whether foreign regulatory requirements adequately reflect the interests and protections associated with the particular Title VII requirement. In some circumstances, such a conclusion may be difficult to achieve.

In the event that we are unable to determine that an entity may satisfy certain Title VII requirements via substituted compliance, we recognize that such persons may, as a result, be subject to requirements that are duplicative of particular Title VII requirements. While we recognize the significance of such a result, in our view compliance with the

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1345 See note 1338, supra (citing ICI Global (July 2015), supra note 10, at 5-6; SIFMA-AMG (July 2015), supra note 10, at 2, 5; IIB (July 2015), supra note 10, at 11; SIFMA/FSR (July 2015), supra note 10, at 9).

1346 See Cross-Border Proposing Release, 78 FR 31085, supra note 6.

Title VII requirements is necessary to advance the policy objectives of Title VII. This would be undermined by permitting foreign dealers to comply with their Title VII obligations by satisfying foreign requirements, unless the alternative route provided by substituted compliance has been made available.

Second, although the Commission is mindful that the U.S. intermediary of a registered foreign SBS Dealer may be subject to business conduct requirements under the Exchange Act and relevant SRO rules and that such requirements may be similar in certain respects to those in Title VII,[1347] the Commission continues to believe that notwithstanding any requirements that may apply to such intermediaries, it is appropriate to impose the Title VII business conduct standards directly on registered foreign SBS Dealers when they use personnel located in the United States to arrange, negotiate, or execute security-based swaps, even with counterparties that are also non-U.S. persons.[1348]

[1347] See U.S. Activity Proposing Release, 80 FR 27476 n.249, supra note 9 (stating that the agent of a foreign SBS Dealer would need to consider whether it separately would need to register as a security-based swap dealer (if, for example, the agent acted as principal in a security-based swap with the counterparty, and then entered into a back-to-back transaction with the booking entity), a broker (e.g., by soliciting or negotiating the terms of security-based swap transactions), or other regulated entity); Cross-Border Proposing Release, 78 FR 31027 n.574, supra note 6 (same).

Commenters urged the Commission to harmonize FINRA's existing sales practice requirements with the "communication-based" or transaction-specific rules applicable under Title VII. See SIFMA/FSR (July 2015), supra note 10, at 9-10; IIB (July 2015), supra note 10, at 13. Commenters also urged the Commission to work toward a harmonized approach to all the business conduct rules with the CFTC and FINRA to ensure that security-based swap dealers and swap dealers are not subject to two different sets of business conduct requirements. See ISDA (July 2015), supra note 10, at 9; IIB (July 2015), supra note 10, at 6, 7.

[1348] See U.S. Activity Proposing Release, 80 FR 27476, supra note 9. Consistent with the Commission's position in the Cross-Border Proposing Release, the dealer and its agent(s) may choose to allocate the responsibility for compliance with all U.S. business conduct requirements in a manner consistent with its business structure,

The Commission continues to believe that it is appropriate to subject all registered SBS Dealers engaged in U.S. business to the same business conduct framework, rather than encouraging a patchwork of business conduct protections under U.S. law that may offer counterparties varying levels of protections and limit the Commission's ability to pursue enforcement actions against the registered SBS Dealer for violation of Title VII depending on the business model that the registered SBS Dealer has chosen to use in its U.S. business.[1349]

Further, as we have previously discussed, Congress established a comprehensive framework of business conduct standards in Title VII that applies to registered SBS Dealers, and we continue to believe that the transactional requirements we adopt to implement this framework should govern their transactions with counterparties when such transactions raise market integrity, transparency, and counterparty protection concerns that are addressed by these requirements.[1350] As we have already noted, SBS

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although the foreign security-based swap dealer would remain responsible for ensuring that all relevant Title VII requirements applicable to a given security-based swap transaction are fulfilled. See U.S. Activity Proposing Release, 80 FR 27476 n.249, supra note 9; Cross-Border Proposing Release, 78 FR 31026-27, supra note 6. This allocation, however, would not affect the non-U.S. person's responsibilities with respect to performing the de minimis calculations required under Rules 3a71-2 and 3a71-3(b). See U.S. Activity Proposing Release, 80 FR 27476 n.249, supra note 9; Cross-Border Proposing Release, 78 FR 31026-27 n.574, supra note 6.

[1349] See U.S. Activity Proposing Release, 80 FR 27476, supra note 9.

[1350] See U.S. Activity Adopting Release, Sections IV.B.2, IV.B.3, and n.162 (describing regulatory concerns raised by security-based swap dealing activity carried out in the U.S., including risk, market integrity and transparency, and counterparty protection). See Section II.G.3, supra (explaining that the "know your counterparty" standard would be consistent with basic principles of legal and regulatory compliance, and operational and credit risk management); Section II.G.2.e, supra (explaining that the daily mark disclosure requirement is directly relevant to a counterparty's understanding of its financial relationship under a

Dealers are involved in an overwhelming majority of SBS transactions in the U.S., meaning that business conduct standards intended to achieve market integrity, transparency, and counterparty protection across the U.S. market in security-based swaps are more likely to achieve these objectives if they apply to all transactions that SBS dealers arrange, negotiate, or execute using personnel located in a U.S. branch or office.[1351]

Some commenters supported dividing the business conduct standards into two categories, one of which they argued should not apply to transactions between two non-U.S. persons. These commenters urged the Commission not to impose "relationship-based" requirements (which they defined to include rules relating to the counterparty's ECP status, "know your counterparty" requirements, daily mark disclosure, and suitability requirements) on these transactions but suggested that imposing "trade-specific" or "communication-based" requirements (which they which they identified as including disclosure of material risks and characteristics and material incentives or conflicts of interest and related recordkeeping, disclosures regarding clearing rights and related recordkeeping, product suitability, and fair and balanced communications and

security-based swap transaction and ensures a counterparty's ability to monitor the transaction during the relationship); Section II.G.4, supra (explaining that the suitability requirement enables security-based swap dealers to understand the risk-reward tradeoff of their security-based swap transactions).

1351 Firms that act as dealers play a central role in the security-based swap market. Based on an analysis of 2014 single name CDS data in TIW, dealer accounts of those firms that are likely to exceed the de minimis thresholds and trigger registration requirements intermediated transactions with a gross notional amount of approximately $8.5 trillion, over 60% of which was intermediated by top 5 dealer accounts. Commission staff analysis of TIW transaction records indicates that approximately 99% of single name CDS price-forming transactions in 2014 involved an ISDA-recognized dealer. See U.S. Activity Adopting Release, 81 FR 8606 n.77.

supervision) could be a reasonable approach, particularly if they were made more consistent with similar FINRA rules that may apply to the U.S. intermediary.[1352]

The Commission does not agree with commenters who argue that the foreign SBS Dealers should be excepted from the "relationship-based" requirements when entering into transactions with other non-U.S. persons.[1353] The Commission believes that applying each of these requirements should improve market integrity and enhance transparency and counterparty protections, even if that dealing activity is entirely with non-U.S.-person counterparties, particularly given that the foreign SBS Dealers that engage in the relevant dealing activity in the United States at levels above the de minimis threshold account for a significant proportion of transactions in the U.S. market. Moreover, certain underlying substantive requirements may require SBS Dealers to obtain representations from counterparties (or to otherwise confirm their status) even absent these business conduct requirements, meaning that, as a practical matter, for example, we would not expect that the requirement in Rule 15Fh-3(a)(1) to verify ECP status would increase the burden on market participants.[1354] Accordingly, the

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1352 See notes 1297-1299, supra.

1353 See note 1298, supra.

1354 The Exchange Act prohibits any person from effecting a security-based swap with a non-ECP unless the security-based swap is effected on a national securities exchange and the Securities Act makes it unlawful 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 unless a registration is in effect. See Section II.G.1.c, supra. See also Section 6(l) of the Exchange Act; Section 5(e) of the Securities Act. Accordingly, section 6(l) is broader than the activity covered by Rule 15Fh-3(a)(1), and the SBS Dealer has an independent obligation under section 6(l) even absent the requirement in Rule 15Fh-3(a)(1), to perform some due diligence in confirming that its counterparty is an ECP. The requirement to verify the ECP-status of a counterparty pursuant to Rule 15Fh-3(a)(1) simply provides a means

Commission does not believe it would be appropriate to provide an exception from these "relationship-based" requirements for foreign SBS Dealers when they are required to comply with the business conduct standards in a security-based swap transaction with a non-U.S.-person counterparty because they have used personnel located in the United States to arrange, negotiate, or execute the transaction.

The Commission recognizes that some non-U.S. person counterparties may express reservations about making certain representations or completing questionnaires to comply with the "relationship-based" business conduct requirements when they have no intention of interacting with the dealer's personnel located in the United States.[1355] At the same time, nothing in the rule requires a registered SBS Dealer to comply with these requirements if it intends to engage in transactions with a counterparty solely as part of its foreign business. If the relationship later develops in such a way that future transactions may be expected to be part of the SBS Dealer's U.S. business, under the final rules the SBS Dealer then would be required to comply with these business conduct standards, including these "relationship-based" requirements.

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for complying with certain of the relevant substantive statutory provisions. See id. See Section II.G.1.c, supra.

1355 See SIFMA/FSR (July 2015), supra note 10, at 8-9. See also ICI Global (July 2015), supra note 10, at 6 (noting that, even though the registered dealer (and not the non-U.S. person) is subject to the business conduct requirements, the non-U.S. person counterparty would likely need to have in place appropriate documentation and representations if its dealer is subject to business conduct requirements, which may cause interruptions in their investment activities); IIB (July 2015), supra note 10, at 11-12 (arguing that non-U.S. counterparties would not expect the "trade-relationship" requirements to apply in their trades with non-U.S. persons and would be surprised to be required to agree to covenants or fill out questionnaires related to U.S. requirements). See note 1298, supra.

As noted above, some commenters acknowledged that the "communication-based" or "trade-specific" requirements likely would advance regulatory objectives, such as the prevention of fraud or manipulation, even in connection with SBS transactions between two non-U.S. persons where one counterparty is using personnel located in the United States to arrange, negotiate, or execute transactions.[1356] They urged, however, that the Commission harmonize its Title VII business conduct standards to existing FINRA rules to the extent that it chooses to impose Title VII requirements on these transactions.[1357] As discussed above, the rules being adopted today are generally designed to be consistent with the relevant SRO requirements (and to harmonize with CFTC requirements), taking into account the nature of the security-based swap market and the statutory requirements for SBS Entities.[1358]

The Commission recognizes that application of these requirements may impose costs on asset managers servicing non-U.S. clients and impede their ability to execute certain block trades.[1359] However, we believe that the rules appropriately balance the regulatory objectives of the business conduct rules with concerns for a workable approach. The rules adopted here are generally applicable to transactions of registered

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1356 See note 1299, supra.

1357 See note 1300, supra.

1358 See Sections I.C and I.F, supra.

1359 See notes 1295 and 1296, supra. Specifically, the commenters expressed concern that, under the proposal, the U.S. asset manager executing a trade on behalf of a non-U.S. client, including in the context of a block trade, would need to know whether the transaction involved U.S. activity and would also need to verify that the non-U.S. client satisfies the business conduct requirements. See SIFMA-AMG (July 2015), supra note 10, at 4; ICI Global (July 2015), supra note 10, at 6 (explaining that regulated fund parties would need appropriate documentation and representations in place to execute such trades and would face interruptions in investment activities in doing so).

SBS Dealers; the rules do not apply directly to asset managers, and asset managers will incur no liability under these rules. We recognize that SBS Dealers may arrange their business in a variety of ways and may have certain expectations of asset managers in connection with the transactions involving funds. The entities involved in the transaction may allocate these costs in the manner most efficient for the counterparties to the transactions. Although the Commission recognizes that, depending on how the SBS Dealer and the asset manager choose to allocate these responsibilities, the asset manager may incur certain costs, neither these private allocation issues nor the potential liquidity or execution price concerns change the Commission's view that the U.S. business of SBS Dealers should be subject to these business conduct requirements.

The Commission also disagrees with the commenters that urged the Commission to permit sophisticated counterparties to "opt-out" completely from the business conduct standards and with commenters that requested that the U.S. Activity Test not be applied to transactions with special entities.[1360] The Commission has considered the concerns raised by commenters and determined, on balance, not to permit counterparties to opt out of the protections provided by the business conduct rules. The rules are intended to provide certain protections for counterparties, including certain heightened protections for special entities. We think it is appropriate to apply the rules so that counterparties

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1360 See IIB (July 2015), supra note 10, at 13; SIFMA/FSR (July 2015), supra note 10, at 10-11 (requesting the non-U.S. counterparty have option to opt-out of "transaction-specific" rules if they apply solely as a result of U.S. activity). See note 1302, supra. See note 1304 (citing IIB (July 2015), supra note 10, at 12; SIFMA/FSR (July 2015), supra note 10, at 9-10).

receive the benefits of those protections and so do not think it appropriate to permit parties to "opt out" of the benefits of those provisions.[1361]

c. Transaction-Level Requirements for Major SBS Participants

As noted above, the Commission is also adopting amendments to Rule 3a67-10 to incorporate a modified exception from the business conduct standards for registered foreign Major SBS Participants.[1362] The Commission received no comments in response to the proposed exception from the business conduct requirement for registered foreign Major SBS Participants in their transactions with non-U.S. persons. However, the final rule is slightly modified from the proposal to address the concerns that non-U.S. persons would limit or stop trading with foreign branches of U.S. banks that led us to adopt a similar exception in the Cross-Border Adopting Release for certain transactions from the position threshold calculations to determine whether one is a Major SBS Participant.[1363]

As proposed, Exchange Act Rule 3a67-10(c), which addressed cross-border application of the definition of "major security-based swap participant," would require non-U.S. persons to count toward the Major SBS Participant thresholds only their

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1361 See Section II.A.3, supra. We also explained above that, while we are not adopting an opt out provision, as discussed in connection with the relevant rules, the Commission has determined to permit means of compliance with the final rules that should promote efficiency and reduce costs (e.g., Rule 15Fh-1(b) (reliance on representations)) and, where appropriate, allow SBS Entities to take into account the sophistication of the counterparty (e.g., Rule 15Fh-3(f) (regarding recommendations of security-based swaps or trading strategies)).

1362 Rule 3a67-10(d).

1363 See Rule 3a67-10. See Cross-Border Adopting Release, 79 FR 47343, supra note 193 (explaining the Commission's view that an exclusion from the counting requirement for positions that arise from transactions conducted through foreign branches of registered security-based swap dealers appropriately accounts for the risk in the U.S. financial system created by such positions).

security-based swap transactions with U.S. persons and would have permitted no exception from that requirement. As adopted, however, in the Cross-Border Adopting Release, the relevant rule (Exchange Act Rule 3a67-10(b)) provides that a non-U.S. person need not include in these threshold calculations its security-based swap positions with a U.S. person to the extent that the positions "arise from transactions conducted through a foreign branch of the counterparty, when the counterparty is a registered SBS Dealer."[1364] This change to the final rule made the Commission's approach to the threshold calculations for Major SBS Participant consistent with its final approach to the SBS Dealer de minimis calculation thresholds under Exchange Act rule 3a71-3(b)(1)(iii)(A)(*1*), which also permitted non-U.S. persons to exclude such transactions with U.S. persons from their de minimis threshold calculations.[1365] The Commission noted that this expanded exception from counting certain security-based swap positions towards a non-U.S. person's Major SBS Participant thresholds should help mitigate concerns that non-U.S. persons will limit or stop trading with foreign branches of U.S. banks.[1366]

The Commission believes similar concerns about the ability of foreign branches of U.S. banks to do business with non-U.S. persons apply in the context of application of the business conduct requirement to these transactions. This exception from the application of the business conduct requirements adopted in the final rules today should address concerns that non-U.S. persons would limit or stop trading with foreign branches

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1364 See Exchange Act rule 3a67-10(b)(3)(i)(A).

1365 See Cross-Border Adopting Release, 79 FR 47343, supra note 193.

1366 See id.

of U.S. banks. The Commission is therefore amending Exchange Act rule 3a67-10 to incorporate exceptions for transactions through the foreign branch of a U.S. person modeled on those that are available in the final rule as it applies to registered SBS Dealers.[1367] Accordingly, the final rules except registered foreign Major SBS Participants from the business conduct standards described in section 15F(h) of the Exchange Act, and the rules and regulations thereunder (other than the rules and regulations prescribed by the Commission pursuant to section 15F(h)(1)(B))[1368] with respect to any transaction with a non-U.S. person, as proposed, or with a U.S. person in a transaction conducted through the foreign branch of the U.S. person.[1369] The final rules also except a registered U.S. Major SBS Participant from the business conduct standards described in section 15F(h) of the Exchange Act, and the rules and regulations thereunder (other than the rules and regulations prescribed by the Commission pursuant to section 15F(h)(1)(B)) [1370] with respect to any transaction of the registered U.S. Major SBS Participant that is a transaction conducted through a foreign branch with a non-U.S.

1367 See Exchange Act rule 3a71-3(a)(8)(i)(A) (excluding from the definition of "U.S. business" of a foreign SBS Dealer any transaction with U.S. persons that constitutes a transaction conducted through a foreign branch of that U.S. person); Exchange Act rule 3a71-3(a)(8)(ii) (excluding from the definition of "U.S. business" of U.S. SBS Dealers any transaction of the U.S. SBS Dealer that is a transaction conducted through a foreign branch with a non-U.S. person or with a U.S.-person counterparty that constitutes a transaction conducted through a foreign branch of the counterparty).

1368 See, supra, notes 1318-1319.

1369 See Exchange Act rule 3a67-10(d)(1). Consistent with the Cross-Border Proposing Release, the Commission is also amending Exchange Act rule 3a67-10(a) to define "foreign major security-based swap participant." See Exchange Act rule 3a67-10(a)(6).

1370 See, supra, notes 1318-1319.

person, or with a U.S.-person counterparty that constitutes a transaction conducted through a foreign branch of the counterparty.[1371]

B. Availability of Substituted Compliance

1. Proposed Substituted Compliance Rule

As part of the Cross-Border Proposing Release, the Commission proposed to make substituted compliance potentially available in connection with the requirements applicable to SBS Dealers pursuant to Exchange Act Section 15F, other than the registration requirements applicable to dealers.[1372] Because the business conduct requirements being adopted today are grounded in Section 15F, substituted compliance generally would have been available for those requirements under the proposal.

The proposal would have specifically provided that a foreign SBS Dealer[1373] could satisfy applicable requirements under Section 15F by complying with comparable regulatory requirements of a foreign jurisdiction.[1374] The Commission explained that a person relying on substituted compliance would remain subject to the applicable Exchange Act requirements, but could comply with those requirements in an alternative

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1371 See Exchange Act rule 3a67-10(d)(2). The Commission is also amending Exchange Act rule 3a67-10(a) to define "U.S. major security-based swap participant." See Exchange Act rule 3a67-10(a)(5).

1372 See Cross-Border Proposing Release, 78 FR at 31088, 31207-08, supra note 6 (proposed Exchange Act Rule 3a71-5).

1373 In the Cross-Border Proposing Release, the Commission proposed to define a "foreign security-based swap dealer" as a security-based swap dealer that is not a U.S. person. See 78 FR at 31206, supra note 6 (proposed Exchange Act Rule 3a71-3(a)(3)).

1374 See Cross-Border Proposing Release, 78 FR at 31207, supra note 6 (proposed Exchange Act Rule 3a71-5(b), providing that a security-based swap dealer may comply with Section 15F requirements by complying with certain corresponding foreign requirements).

fashion. Failure to comply with the applicable foreign requirement would mean that the person would be in violation of the requirement in the Exchange Act.[1375]

The Commission further explained that allowing substituted compliance for the dealer requirements would have the goal of increasing the efficiency of the security-based swap market and promoting competition "by helping to avoid subjecting foreign security-based swap dealers to potentially conflicting or duplicative compliance obligations, while still achieving the policy objectives of Title VII." The Commission also stated that such an approach would be consistent with the global nature of the security-based swap market, and may be less disruptive of business relationships than not permitting substituted compliance.[1376]

Under the proposal, the Commission would not permit dealer requirements to be satisfied by substituted compliance unless the Commission determined that the foreign regime's requirements were comparable to the otherwise applicable requirements, after taking into account such factors as the Commission determines are appropriate, including the scope and objectives of the relevant foreign regulatory requirements and the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by the foreign financial regulatory authority in support of its oversight.[1377]

The Commission also stated that in making a substituted compliance determination, it would focus on the similarities in regulatory objectives, rather than

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1375 See id. at 31085.

1376 See id. at 31089-90.

1377 See id. at 31086-88.

requiring that the foreign jurisdiction's rules be identical. Moreover, depending on the assessment of comparability, the Commission could condition the substituted compliance determination by limiting it to a particular class or classes of registrants in the foreign jurisdiction.[1378]

The proposal would have required that, prior to making a substituted compliance determination, the Commission must have entered into a supervisory and enforcement memorandum of understanding ("MOU") or other arrangement with the foreign authority addressing the oversight and supervision of security-based swap dealers subject to the substituted compliance determination.[1379] The proposal further provided for the potential withdrawal of substituted compliance orders, after notice and comment.[1380] In addition, the proposal would have required that a foreign security-based swap dealer could not submit a substituted compliance request unless it is directly supervised by the foreign financial regulatory authority, and the security-based swap dealer provides a certification and opinion of counsel that the security-based swap dealer can provide the Commission

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1378 See id. at 31088. The Commission added that it intended to take a category-by-category approach toward substituted compliance under the proposal, and that "certain requirements are interrelated such that the Commission would expect to make a substituted compliance determination for the entire group of related requirements." See id. at 31088-89 (further stating that the Commission anticipated considering substituted compliance related to capital and margin requirements in connection with requirements related to risk management, recordkeeping and reporting, and diligent supervision).

1379 See id. at 31088.

1380 See id. at 31089 (citing as an example changes in the foreign regulatory regime or a foreign regulator's failure to exercise its supervisory or enforcement authority in an effective manner).

with prompt access to its books and records, and that the security-based swap dealer as a matter of law can submit to onsite inspection and examination by the Commission.[1381]

Under the proposal, substituted compliance would not have been available to Major SBS Participants. In this regard, the Commission particularly noted "the limited information currently available to us regarding what types of foreign entities may become major security-base swap participants, if any, and the foreign regulation of such entities."[1382]

2. Comments on the Proposal

Commenters raised issues in connection with a variety of aspects regarding the proposed substituted compliance rule:

- Basis for substituted compliance. One commenter to the Cross-Border Proposing Release questioned the Commission's authority to grant substituted compliance,[1383] and expressed skepticism regarding the policy basis for

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1381 See id. at 31089 & n.1126.

1382 See id. at 31035-36.

1383 See Better Markets (August 2013), supra note 7, at 24 ("Nowhere does the SEC address its authority for adopting such a framework, nor does it explain how the possibility of 'conflicting or duplicative compliance obligations' [justifies] supplanting Congress's determination that, to protect the American taxpayer and economy, those subject to the Commission's jurisdiction must comply with the actual provisions of the Dodd-Frank financial reform law.").

This commenter particularly described the use of substituted compliance as constituting an impermissible exemption from the Title VII requirements, stating: "Had Congress intended the SEC to permit compliance with foreign regulation to suffice for all Title VII regulation of entities under U.S. jurisdiction, directly or by way of anti-evasion regulations, it certainly could have done so." In support, the commenter cited Exchange Act section 17A(k), 15 U.S.C. 78q-1(k), added by Dodd-Frank, which specifically permits the Commission to exempt clearing agencies from registration when they are subject to comparable and

permitting the use of substituted compliance to satisfy Title VII requirements.[1384] That commenter further suggested that any Commission relief should be used sparingly, and should be predicated on a finding that there is an actual conflict between Title VII and foreign requirements.[1385]

- Availability to U.S. persons. One commenter suggested that substituted compliance for the dealer requirements should be available to foreign branches of U.S. persons,[1386] while another commenter opposed the availability of substituted compliance to U.S. persons.[1387] One commenter

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comprehensive oversight by the CFTC or by foreign regulators. See Better Markets (August 2013), supra note 7, at 25.

1384 See Better Markets (August 2013), supra note 7, at 24-25 ("The SEC's duty is to protect investors and the public consistent with congressional policy, not to minimize the costs, burdens, or inconvenience that regulation imposes on industry. This is particularly important when any claimed industry burden is not only self-serving, but without basis and entirely speculative."). The commenter also alluded to potential loopholes associated with opportunities for regulatory arbitrage, encouraging "a race to the regulatory bottom so that financial firms can increase profits by avoiding regulations that protect the American people and taxpayers," and that the "financial industry is among the most notorious business sectors for searching the globe to exploit such loopholes." See id.

1385 See Better Markets (August 2013), supra note 7, at 26 ("Rather than following a substituted compliance approach, the SEC should use its exemptive authority sparingly, and only upon a finding of actual conflict with a particular foreign regulation.").

1386 See SIFMA (August 2013), supra note 7, at A-33 (stating that not allowing substituted compliance for foreign branches in connection with confirmation requirements and certain other requirements would put foreign branches at a competitive disadvantage to foreign dealers, although foreign branches "are, in most cases, subject to extensive supervision and oversight in their host country"; further noting that the Commission proposed to allow substituted compliance for foreign branches in connection with regulatory reporting, public dissemination and trade execution requirements).

1387 See Better Markets (August 2013), supra note 7, (generally opposing substituted compliance for U.S. persons, including foreign branches, and stating that allowing

expressed the view that substituted compliance should be made available to U.S. persons in connection with transactions with non-U.S. persons,[1388] while another stated that substituted compliance should be made available to U.S. persons in connection with all transaction-level requirements.[1389]

- Availability in connection with U.S. business. One commenter expressed the view that substituted compliance generally should not be available in connection with transactions involving U.S. counterparties, or in connection with transactions that occur within the U.S.[1390]
- Comparability criteria. Certain commenters opposed the proposed holistic approach toward assessing comparability based on regulatory outcomes, and instead expressed the view that any assessments should be done on a

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substituted compliance in those circumstances would constitute "carve-outs" that would "essentially nullify U.S. law in favor of foreign regulatory requirements").

1388 See ESMA, supra note 8, at 3-4 (expressing the view that "substituted compliance should apply when a counterparty to the derivative transaction is established in an equivalent jurisdiction and is a non-US person. In such case, substituted compliance should be possible whatever the status of the other party is, including if it is a U.S. person, and whatever the place out of which the transaction is conducted or executed.").

1389 See MFA/AIMA, supra note 8 (stating the Commission should extend substituted compliance to "to all transaction-level requirements that apply to U.S. and non-U.S. persons," and that "by extending the scope of substituted compliance to all market participants, irrespective of their 'U.S. person' status, and to all regulatory categories . . . the Commission would mitigate the risk of duplicative and/or conflicting regulatory requirements, without curtailing the reasonable application of Title VII of Dodd-Frank to relevant market participants").

1390 See Better Markets (August 2013), supra note 7, at 26-27 ("The SBS activities of a U.S. person directly and immediately impact the United States and endanger the U.S. taxpayer if improperly regulated. . . . Substituted compliance is simply impermissible for transactions with U.S. persons or for transactions that occur within the United States, regardless of the status of the counterparty.").

requirement-by-requirement basis.[1391] Conversely, a number of commenters supported the proposed approach.[1392] Some commenters requested further clarity regarding the assessment criteria and regarding the information that should be submitted in support of applications,[1393] while one commenter

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1391 See AFR (stating that an "'outcomes-based' assessment of regulation is thus likely to be far more subjective than a careful, point-by-point comparison of the actual substance of the rules," and that "a hypothesized similarity in outcomes for sets of rules that are quite different in substance should not suffice to certify comparability"; further stating that an outcomes-based assessment may not be consistent with the need for different sets of requirements to be standardized); Better Markets, supra note 7, (August 2013) at 3, 30 (stating that the SEC must abandon the regulatory outcomes test and must ensure that foreign regulation is comparable in substance, form, over time, and as enforced," and also questioning whether "one can ever predict whether regulatory outcomes will be comparable").

A legislative comment letter to the CFTC in connection with the CFTC's own cross-border initiative, on which the SEC Chair and Commissioners were copied, also took the view that there should be a presumption against comparability for substituted compliance purposes and that any assessment be made on a requirement-by-requirement basis. See U.S. Senators, supra note 8 ("However, the 'substituted compliance' determination must be made through a judicious process, on a country-by-country and requirement-by-requirement basis, and subject to a presumption that other jurisdictions do not comply unless proven otherwise.").

1392 See, e.g., SIFMA (August 2013), supra note 7, at A-30 (the proposed approach "is consistent with the goal of international comity and is preferable to a rule-by-rule comparison"); IIB (August 2013), supra note 8, at 18 ("We agree with the Commission that requirements related to internal controls (such as risk management, recordkeeping and reporting, internal systems and controls, diligent supervision and chief compliance officer requirements) should generally be evaluated holistically. These requirements are commonly overseen and administered by a single prudential regulator."); EC, supra note 8 ("We support the consideration of regulatory outcomes as the standard for permitting substituted compliance, as well as the consideration of particular market practices and characteristics in individual jurisdictions. This flexible approach recognises the differing approaches that regulators and legislators may take to achieving the same regulatory objectives in the derivatives markets."); ABA (October 2013), supra note 8.

1393 See SIFMA (August 2013), supra note 7 (requesting that the Commission provide a "more granular and detailed framework" for clarity regarding the assessment

challenged the proposal's lack of particularized elements for assessing comparability in connection with certain requirements.[1394] One commenter questioned how the Commission would be notified of material changes to foreign law that underpins a substituted compliance determination.[1395] Commenters also expressed the views that regulatory comparisons should focus on common principles associated with shared G-20 Leaders goals,[1396]

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process, including the factors relevant to the determination and the method and metrics for comparing regulatory outcomes); CDEU, supra note 8 (addressing vagueness in criteria); ISDA (August 2013), supra note 7, at 3 ("Without a more concrete definition of the outcomes-based standard, applicants will face uncertainty in determining what information should be supplied in connection with an application. ISDA proposes that the appropriate 'outcomes' to guide substituted compliance determinations should be the common principles based on the consensus G-20 goals as described above, rather than details of domestic legislation; in other words, a substituted compliance determination should be an assessment that the non-US regulatory approach under consideration adheres to the common principles."); FOA, supra note 8 (requesting additional detail regarding relevant regulatory outcomes).

1394 See Better Markets (August 2013), supra note 7, at 30 (noting that the Commission proposed particularized comparability elements in connection with regulatory reporting and public dissemination requirements, and stating that the lack of such elements for other requirements would be confusing and would create "the opportunity for the Commission to approve much more relaxed foreign regulations based on more vague standards"; further stating that it would be arbitrary and capricious not to make use of "consistently robust and publicly disclosed" standards to guide substituted compliance determinations for each requirement).

1395 See Better Markets (August 2013), supra note 7, at 29 ("Any entity making use of substituted compliance must be held responsible for immediately informing the SEC if either the relevant regulation or the factors that qualified the entity for substituted compliance change in any material way.").

1396 See ISDA (August 2013), supra note 7 (stating that "the Commission could consider and adopt a regime-based approach, whereby comparability would exist if a jurisdiction has implemented regulations to meet the G-20 commitments. The Commission's rejection of this approach based on its 'responsibility to implement the specific statutory provisions ... added by Title VII' overlooks the principle that

urged the need for consistency and coordination with the work of other regulators and IOSCO,[1397] and supported building on existing cooperative initiatives.[1398] Commenters also stated that the Commission should coordinate substituted compliance determinations with the CFTC.[1399] One commenter expressed concern regarding operational complexities that may be associated

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comity should inform the extraterritorial application of statutory directives"; citation omitted).

1397 See II.F, supra note 8 ("Nevertheless, the proposed approach (and any similar approaches used in other jurisdictions) will be even more effective and beneficial if they are consistent with, and coordinated with, the work and approaches of other authorities in the same jurisdiction (particularly in the case where multiple supervisors have responsibility for swaps regulation), national authorities in other jurisdictions and international standard setters such as the International Organization of Securities Commissions (IOSCO).").

1398 See JSDA, supra note 8 (noting that the CFTC and the European Union had announced a "Path Forward" regarding their joint understandings for how to approach cross-border derivatives, and stating "[w]e expect that the SEC and CFTC will jointly adopt the same approach regarding application of substituted compliance to Japan").

1399 See, e.g., CDEU, supra note 8 ("The SEC should also work closely with the CFTC when determining whether substituted compliance is applicable with respect to a particular jurisdiction. With respect to substituted compliance, the regulatory requirements of end-users operating globally depend on whether the SEC has made a comparability determination for the relevant non-U.S. jurisdiction. Conflicting regimes will lead to increased costs and unnecessary duplicative regulations which may be directly or indirectly imposed on derivatives end users."); ISDA (August 2013), supra note 7 ("Differences in the Commission's and CFTC's approaches to derivatives regulation produce uncertainties and confusion for market participants. Moreover, the lack of coordination severely limits potential efficiencies in the substituted compliance process. We note here some of the significant differences between the Proposal and the CFTC July 2013 Guidance. We respectfully urge the agencies to prioritize harmonization of their approaches to substituted compliance."). But see ISDA (August 2013), supra note 7 (commending the Commission's proposal "to allow substituted compliance by bona fide non-US SBS dealers for external business conduct standards and conflicts of interest duties in transactions with U.S. persons," in contrast to the approach set forth in the CFTC's cross-border guidance).

with "partial" substituted compliance determinations, and suggested that there be presumptions against such partial determinations.[1400]

- Enforcement and supervisory practices. One commenter expressed the view that a substituted compliance assessment must address a foreign regime's supervisory and enforcement capabilities in practice.[1401] Another commenter expressed the view that differences among the supervisory and enforcement regimes should not be assumed to reflect flaws in one regime or another.[1402]

1400 FOA, supra note 8 (urging the Commission to be sensitive to "the possible consequences of 'partial' substituted compliance determination for market participants and, wherever possible, to presume that where a significant portion of a jurisdiction's regulatory regime is determined to be comparable to Title VII of the Dodd-Frank Act, the remainder of the jurisdiction's regulatory regime should also be deemed to be comparable").

1401 This commenter also highlighted particular factors for analysis of foreign supervision and enforcement. See Better Markets (August 2013), supra note 7, at 29-31 (stating that the "foreign regulatory regime must incorporate strong investigative tools and meaningful penalty provisions, and the foreign regulator must have a demonstrable commitment to enforcement and the resources to carry out such a commitment," that the Commission "must evaluate a host of factors regarding the foreign regulatory system, including staff expertise, agency funding, agency independence, technological capacity, supervision in fact, and enforcement in fact," and that the Commission "must determine that there is a track record of robust enforcement by the foreign jurisdiction before making or renewing any such finding").

Another commenter more generally supported the Commission's ability to not grant substituted compliance due to the substantive enforcement of foreign regulatory regimes. See AFR, supra note 8 (also supporting withdrawal of substituted compliance due to a foreign regulator's failure to exercise its supervisory or enforcement authority).

1402 See ISDA (August 2013), supra note 7 ("While the G-20 commitments for the reform of derivatives markets are globally shared, supervisory practices vary significantly among jurisdictions. Supervisory practices established in one jurisdiction will be adapted to the facts of that jurisdiction. This lack of commonality should not be assumed to be a defect in supervisory standards; common objectives may be reached through differing means. Moreover, commonality may not present meaningful benefits beyond those already achieved

One commenter requested guidance regarding how the Commission would consider such enforcement and supervisory practices.[1403]

- Multi-jurisdictional issues. One commenter raised questions regarding the application of substituted compliance in connection with third-country branches of non-U.S. dealers,[1404] while another commenter raised issues regarding which sets of rules apply to transactions between parties in different markets, and whether the parties to cross-jurisdiction transactions may choose which rules apply.[1405] Commenters also raised issues regarding the assessment of substituted compliance in the context of the European Union,

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by virtue of the Commission and its counterpart regulators negotiating and entering into memoranda of understanding, a process that is separately a predicate for substituted compliance.").

1403 See ABA, supra note 8 ("In addition, we believe that the Commission's comparability analysis should extend to the existence and effectiveness of the foreign jurisdiction's supervisory examination and enforcement programs. However, we urge the Commission to provide further guidance as to how these factors will be analyzed in particular scenarios.").

1404 See FOA, supra note 8 ("However, multi-jurisdictional scenarios are quite common and the SEC must provide additional guidance on how it intends to address substituted compliance when a bank headquartered in one country (e.g., the UK) may have a swap dealing branch that operates in another country (e.g., Hong Kong). Any substituted compliance determination by the SEC must account for the interplay of the regulatory regimes in the relevant non-US jurisdictions.").

1405 See IIF, supra note 8 ("A further general observation is that while the rule proposal provides for substituted compliance covering significant aspects of entity-level and transaction-level requirements, it does not seem to address the issue of whose rules govern when the transaction is between two or more parties in different markets. It is important that the SEC provide guidance as to how one determines the applicable requirements in such cases. We suggest that the final rule should clarify that if the SEC has concluded on the basis of its outcomes-based assessment that the rules of the host country where the counterparties are located produce comparable outcomes to those in the United States, then either the parties should be free to choose which rules apply or the rules where the [transaction] occurs should be the default position.").

stating that certain rules are adopted at a European level and are applied directly in individual member states.[1406]

- Deference and coordination. One commenter suggested that the Commission should defer to non-U.S. oversight when possible.[1407] Commenters further questioned the proposed requirement that an applicant for substituted compliance certify that the Commission can access the firm's books and records and conduct onsite inspections of the firm.[1408] One commenter

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1406 See ESMA, supra note 8 ("ESMA considers it is important that substituted compliance is assessed at the level of the jurisdiction, i.e. at the level of the Union, for Europe. EMIR rules are adopted at European level and apply directly in each Member State"); FOA, supra note 8, at 5 ("It is not clear how the SEC intends to approach situations where more than one non-US jurisdiction's rules may be relevant. To some extent, these risks may be mitigated in the European Union to the extent that the SEC makes a substituted compliance determination on an EU-wide basis.").

1407 See ISDA (August 2013), supra note 7, at 6-7 ("In order to minimize the burden of duplicative inspection requests, the Commission should defer to the maximum extent possible to oversight by the non-US regulatory authorities. Such an approach would recognize the inherent limitations on the Commission's capability to interpret non-US regulation and determine whether conduct is compliant.").

1408 See ISDA (August 2013), supra note 7, at 6 ("ISDA requests that the Commission articulate a clear rationale for the inspection powers stipulated in footnote 1126 of the Proposal, as well as a set of principles setting forth how such powers would be used."); ESMA, supra note 8 ("The objective of substituted compliance and the necessary cooperation of the non-US authorities that accompany such a determination should not be pre-empted by an invasive approach based on direct access to all books and records and on-site inspections which are not conducted in a coordinated manner with the home jurisdiction competent authority."). The underlying part of the Cross-Border Proposing Release discussed how the proposing release for the registration requirement would require that nonresident security-based swap dealers provide the Commission with an opinion of counsel concurring that as a matter of law the firm may provide the Commission with prompt access to the firm's books and records, and submit to onsite inspection and examination by the Commission. See Cross-Border Proposing Release, 78

expressed the view that the Commission's ability to access the books and records of, and inspect, a dealer relying on substituted compliance should be subject to agreement with a foreign jurisdiction.[1409]

- Implementation and phase-in periods. Some commenters suggested that certain requirements be deferred pending action on related substituted compliance determinations.[1410] Commenters also stated that any withdrawal

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FR at 31089 n.1126, supra note 6. The Commission has since adopted that requirement. See Registration Adopting Release, 80 FR at 48981, supra note 989.

1409 See FOA, supra note 8 ("The FOA believes that the SEC's access to the books and records of, and the right to conduct on-site examinations and inspections of, a non-US security-based swap dealer relying on a substituted compliance determination should be subject to the terms of the relevant Memorandum of Understanding (or other agreement) governing such substituted compliance arrangements. The FOA therefore urges the SEC to clarify in its final cross-border rules that, as part of a substituted compliance determination, the SEC agrees to access books and records, and conduct on-site examinations and inspections, of non-US security-based swap dealers through the cooperative arrangements entered into with the relevant non-US regulator(s).").

1410 See, e.g., FOA, supra note 8 (suggesting that the Commission consider "a phased implementation process" for substituted compliance, whereby the Commission would "consider delaying the effectiveness of the compliance obligations applicable to non-US security-based swap dealers and major security-based swap participants until such time as the SEC has been able to make substituted compliance determinations in respect of those jurisdictions that are most active in the international derivatives markets"; also supporting a "temporary" substituted compliance regime whereby, following submission of a substituted compliance request, "market participants from that jurisdiction would be permitted to continue to comply with home country regulations until such time as the SEC determines that it will not permit substituted compliance in respect of some, or all, of such home country's regulatory requirements"); ABA, supra note 8 ("However, we recommend that the Commission further clarify the details of its proposed substituted compliance analysis; for example, by indicating that it will consider deferring the application of relevant entity-level requirements pending final action on a particular request."); SIFMA (August 2013), supra note 7 ("[W]e believe that Foreign SBSDs should be provided relief from compliance with Entity-Level Requirements until the Commission has had the opportunity to provide substituted compliance determinations. We believe that this is preferable to requiring Foreign

or modification of a substituted compliance determination by the Commission should also be subject to a phase-in period.[1411]

- Availability to major participants. Two commenters disagreed with the proposal that substituted compliance not be available to major security-based swap participants.[1412] In contrast, one commenter expressed opposition to the possibility of making substituted compliance available to major participants.[1413]

SBSDs to have to build the technological, operational and compliance systems required to comply with U.S. law for a short, interim period. This should be the case so long as that period of time is anticipated to be reasonably brief and the Commission anticipates a possibility that the finalized regulations will be sufficiently comparable.").

1411 See SIFMA (August 2013), supra note 7, at A-36-37 ("[M]arket participants are likely to design systems and processes to comply with an approved substituted regulatory regime after the Commission has made such a determination. Withdrawal or modification of such a determination could cause significant operational difficulties for market participants, that may have to realign their internal infrastructure to be in compliance with the Commission's requirements."); FOA, supra note 8 ("any decision by the SEC to modify or withdraw a substituted compliance determination should be subject to an appropriate phased timetable to permit market participants sufficient time to adjust their systems and operations to the new compliance obligations").

1412 See SIFMA (August 2013), supra note 7, at A-34 ("Without this allowance, MSBSPs subject to comparable regulation in their home jurisdiction would be forced to comply with duplicative or potentially conflicting regulatory regimes."); IIB (August 2013), supra note 8, at 22 ("We see no reason why such institutions, if they exceed one of the MSBSP thresholds, should be no less eligible for substituted compliance than a foreign SBSD.").

1413 See Better Markets (August 2013), supra note 7, at 29 (supporting proposed approach, citing lack of data and limited information, and adding that the Commission should not consider substituted compliance for major participants "until and unless industry participants provide reliable and comprehensive data proving that it would be otherwise prudent to do so").

- Other. In response to questions posed by the Cross-Border Proposing Release, certain commenters opposed certain potential limitations to the availability of substituted compliance.[1414] One commenter supported a standard timeframe for the review of substituted compliance applications.[1415]

3. Response to Comments and Final Rule

After considering the comments received, the Commission is adopting Rule 3a71-6 to make substituted compliance potentially available in connection with the business conduct requirements being adopted today.[1416] The final rule has been modified from the proposal in a number of ways, including, as discussed below: consistent with the scope of the current rulemaking, the final rule solely addresses the use of substituted compliance to satisfy those business conduct requirements (rather than addressing the availability of substituted compliance more generally in connection with section 15F

1414 See, e.g., ISDA (August 2013), supra note 7, at 7 (opposing potential conditions requiring that U.S. counterparties be qualified institutional buyers or qualified investors, and opposing any use of a threshold requirement that non-U.S. security-based swap dealers predominantly engage in non-U.S. business); ABA, supra note 8 (opposing limiting substituted compliance to qualified institutional buyers or qualified investors); see also Cross-Border Proposing Release, 78 FR at 31091-92, supra note 6 (soliciting comment on those potential limitations to the availability of substituted compliance).

1415 See FOA, supra note 8 ("The FOA recognises that the timeline for reviewing a request for substituted compliance and reaching an informed decision will likely vary, for example due to the nature of the regulatory regime in a given jurisdiction or the SEC staff's lack of familiarity with a particular jurisdiction's approach. Nevertheless, the FOA believes that it is essential that there be a standard timeframe for the SEC to reach a substituted compliance determination. Any uncertainty regarding the timeline for compliance with regulatory obligations creates a significant amount of additional complexity for market participants that are already faced with substantial operational and compliance burdens in preparing for the compliance dates of new regulations.").

1416 The final rule has been renumbered from the proposal.

requirements other than registration requirements, as proposed);[1417] and the final rule makes substituted compliance potentially available to registered Major SBS Participants (rather than limiting the potential availability of substituted compliance to registered SBS Dealers, as proposed).[1418]

a. Basis for Availability of Substituted Compliance in Connection with Business Conduct Requirements

As discussed elsewhere, the security-based swap market is global, with a prevalence of cross-border transactions within that market.[1419] The cross-border nature of this market poses special regulatory challenges in connection with the rules we are adopting today, in that the Title VII business conduct requirements applicable to SBS Dealers or Major SBS Participants have the potential to lead to requirements that are duplicative of or in conflict with applicable foreign business conduct requirements, even when the two sets of requirements implement similar goals and lead to similar results. Such results have the potential to disrupt existing business relationships and, more generally, to reduce competition and market efficiency.

The Commission accordingly proposed to implement a substituted compliance framework "to address the effect of conflicting or duplicative regulations on competition and market efficiency and to facilitate a well-functioning global security-based swap market."[1420] In the Commission's view, under certain circumstances it may be appropriate to allow for substituted compliance whereby market participants may satisfy

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1417 See Section III.B.3.b, infra.

1418 See Section III.B.3.c, infra.

1419 See Section VI.B.3, infra.

1420 See Cross-Border Proposing Release, 78 FR at 31086, supra note 6.

certain of the Title VII business conduct requirements by complying with comparable foreign requirements. In this manner, registered entities could comply with a single set of requirements where substituted compliance is deemed appropriate, while remaining subject to robust oversight. Accordingly, substituted compliance may be expected to help achieve the goals of Title VII in a way that promotes market efficiency, enhances competition and facilitates a well-functioning global security-based swap market.

In reaching this conclusion, the Commission notes that one commenter has questioned the Commission's authority to grant substituted compliance and has expressed skepticism regarding the policy basis for permitting the use of substituted compliance to satisfy Title VII requirements.[1421] In contrast to the suggestion of that comment, however, substituted compliance does not constitute exemptive relief and does not excuse registered SBS Entities from having to comply with the Exchange Act business conduct requirements. Instead, substituted compliance provides an alternative method of satisfying those requirements under Title VII.

Moreover, the same commenter's view that substituted compliance would lead to a lowering of regulatory standards is addressed by the provision that any grant of substituted compliance would be predicated on there being comparable requirements in the foreign jurisdiction. Indeed, in the Commission's view, the potential for substituted compliance will help to promote the effective application of Title VII requirements, by making it less likely that certain market participants that are complying with comparable foreign requirements will determine that they need to choose between modifying their

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[1421] See notes 1383 and 1384, supra.

business conduct systems to reflect the requirements of U.S. rules, or else limiting or ceasing their participation in the U.S. market.[1422]

This commenter also expressed the view that any Commission action of this nature at a minimum should be predicated on a finding that there is an actual conflict between Title VII and foreign requirements.[1423] In the Commission's view, however, requiring a showing of actual conflict as a condition to substituted compliance should not be necessary as substituted compliance is intended to promote compliance efficiencies in connection with potentially duplicative requirements (as well as conflicting requirements).[1424]

b. Structure and Scope of the Final Rule

i. In General

As noted, the final rule has been revised from the proposal to reflect that until other Title VII rules are adopted, substituted compliance will be available only with respect to the business conduct rules. The Commission expects to assess the potential

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1422 The Commission further notes that section 752(a) of the Dodd-Frank Act in part requires that the Commission consult with the foreign regulatory authorities on the establishment of consistent regulatory standards with respect to the regulation of security-based swaps. The use of substituted compliance to help mitigate the impacts of inconsistent and duplicative requirements is consistent with that statutory direction.

1423 See note 1385, supra.

1424 In light of the benefits associated with substituted compliance, the final rule also does not include potential limitations, for which the proposing release solicited comment, that would have conditioned substituted compliance on a non-U.S. entity not transacting with U.S. counterparties that are not qualified institutional buyers or qualified investors, or that would have required that non-U.S. entities receiving substituted compliance predominantly engage in non-U.S. business. See note 1414, supra.

availability of substituted compliance in connection with other requirements when the Commission considers final rules to implement those requirements.

To implement this revised approach, paragraph (a)(1) of Rule 3a71-6 as adopted provides that the Commission may, conditionally or unconditionally, by order, make a determination with respect to a foreign financial regulatory system that compliance with specified requirements under that foreign financial regulatory system by a registered SBS Dealer and/or by a registered Major SBS Participant – each a "security-based swap entity" under the rule – or class thereof, may satisfy the corresponding requirements identified in paragraph (d) of rule 3a71-6 that would otherwise apply.[1425] Paragraph (d),

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[1425] See Exchange Act Rule 3a71-6(a)(1). The proposed rule would have made substituted compliance potentially available for all of the section 15F dealer requirements other than registration requirements. The structure of the final rule implements a more targeted approach whereby the Commission will assess the availability of substituted compliance when the Commission considers the applicable substantive rules. Consistent with this approach, the final rule does not include proposed paragraph (a)(3), which would have specified that substituted compliance would not be available in connection with the registration requirements of section 15F. See generally Registration Adopting Release, 80 FR at 48972-73, supra note 989 (determining that substituted compliance would not be available in connection with the registration requirements for security-based swap dealers, and stating that "[p]ermitting a foreign SBS Dealer to satisfy these requirements through compliance with the relevant requirements in its home jurisdiction, even with appropriate notice of such compliance to the Commission, may deprive the Commission of the necessary information, including information resulting from inspection and examination of the books and records of a firm engaged in dealing activity at levels above the de minimis threshold.").

Paragraph (a)(1) of the final rule also has been modified from the proposal to remove language limiting substituted compliance to "foreign" entities. Substituted compliance for the business conduct standards at issue here will be available only to foreign security-based swap dealers and foreign major security-based swap participants, and the Commission expects to assess whether substituted compliance should be limited to foreign entities in connection with other section 15F requirements.

discussed below, is an addition from the proposal that specifies the business conduct requirements that the Commission is adopting.[1426]

Paragraph (a)(2) of the final rule provides that the Commission will not make a substituted compliance determination unless it determines that the foreign requirements applicable to the SBS Entity (or class thereof), or to the activities of such entity (or class thereof), are comparable to the otherwise applicable requirements, after taking into account such factors as the Commission determines are appropriate, such as the scope and objectives of the relevant foreign regulatory requirements (taking into account applicable criteria set forth in paragraph (d)), as well as the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by the foreign authority to support its oversight of the SBS Entity (or class thereof) or of the activities of the entity (or class thereof). This provision has been revised from the proposal in part to make the rule more flexible, by permitting substituted compliance to be predicated either on foreign regulation of the entity (or class), or, alternatively, on foreign regulation of the entity's (or class's) activities. In this way, the rule can account for situations in which a foreign regulatory regime does not specifically provide for the registration of a particular category of market participant, but nonetheless effectively regulates the activities of members of that category.[1427]

1426 Exchange Act Rule 3a71-6(d).

1427 In other words, for example, under the final rule the Commission may make substituted compliance available in connection with a foreign regulatory regime that does not make use of a specific registration category for dealers in security-based swaps, but that nonetheless regulates such dealers in a manner that is comparable to the section 15F requirements.

As proposed, paragraph (a)(2) made no mention of particular criteria associated with a substituted compliance determination. Paragraph (a)(2) of the final rule,

Paragraph (a)(2) of the rule further provides that the Commission will not make a substituted compliance determination unless the Commission has entered into a supervisory and enforcement memorandum of understanding and/or other arrangement with the relevant foreign financial regulatory authority addressing supervisory and enforcement cooperation and other matters arising under the substituted compliance determination.[1428] This provision should help ensure that both regulators will cooperate with each other within the substituted compliance framework, such that both regulators have information that will assist them in fulfilling their respective regulatory mandates. Moreover, the Commission may, on its own initiative, by order, modify or withdraw a substituted compliance determination after appropriate notice and opportunity for comment.[1429]

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however, specifies that in considering the scope and objectives of the relevant foreign requirements, the Commission intends to consider applicable criteria that are set forth in new paragraph (d). See Section III.B.3.e, infra.

1428 See Exchange Act Rule 3a71-6(a)(2)(ii). Paragraph (a)(2)'s reference to supervisory and enforcement cooperation and other matters further has been revised from the proposal, which addressed the "oversight and supervision" of applicable security-based swap dealers. This change is to help ensure that enforcement cooperation is encompassed within those arrangements, given the importance of enforcement in promoting compliance with applicable requirements. The change parallels comparable language in the substituted compliance rules applicable to Regulation SBSR. See Regulation SBSR 908(c)(2)(iv).

1429 See Exchange Act Rule 3a71-6(a)(3).

Commenters stated that any withdrawal or modification of a substituted compliance determination by the Commission should also be subject to a phase-in period. See note 1411, supra. The final rule does not contain any such provision for a phase-in period, however, given that substituted compliance is predicated on the relevant foreign requirements being comparable to the Title VII requirements, and on the adequacy of the relevant foreign authority's supervision and enforcement in connection with those foreign requirements. Subject to that principle, the Commission in practice would expect to consider such timing and

Paragraph (b) of the final rule specifies that a registered SBS Entity may satisfy the Exchange Act requirements identified in paragraph (d) of the rule by complying with corresponding law, rules and regulations under a foreign financial regulatory system, provided that: (1) the Commission has made a determination providing that compliance with specified requirements under the foreign financial regulatory system by such registered security-based swap entity (or a class thereof) may satisfy the corresponding requirements, and (2) such entity satisfies any conditions set forth in the Commission's determination.[1430]

Paragraph (c) of the final rule addresses requests for substituted compliance determinations. As discussed below, those application provisions have been revised from the proposal in certain respects.[1431]

To implement the final rule's targeted approach toward substituted compliance, paragraph (d) of rule 3a71-6 states that substituted compliance will be available in connection with the business conduct and supervision requirements of sections 15F(h)

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operational issues in the event that it were to reconsider a previous grant of substituted compliance. The particular facts and circumstances surrounding such a reconsideration would be relevant to how long substituted compliance would remain available after Commission action.

1430 See Exchange Act Rule 3a71-6(b). This paragraph has been changed from the proposal in certain ways consistent with the changed scope of the rule (i.e., deleting the word "foreign" and replacing "dealer" with "entity") or for clarifying purposes. This paragraph also has been changed from the proposal, which referred to "legislative requirements, rules and regulations," to more flexibly account for the variety of potential sources of applicable requirements.

1431 See Section III.B.3.h, infra.

and 15F(j) and rules 15Fh-3 through 15Fh-6, and the CCO requirements of section 15F(k) and rule 15Fk-1, subject to exceptions discussed below.[1432]

As discussed below, moreover, paragraph (d) specifies that prior to making these substituted compliance determinations, the Commission intends to consider whether the information required to be provided to counterparties pursuant to the requirements of the foreign jurisdiction, the counterparty protections of the foreign jurisdiction, the mandates for supervisory systems under the requirements of the foreign jurisdiction, the duties imposed by the foreign jurisdiction, and the CCO requirements of the foreign jurisdiction, are comparable to the Exchange Act requirements.[1433] Those factors are relevant to the comparability analysis, and their inclusion in the final rule also responds to commenters that expressed the view that the rules should provide more guidance regarding comparability criteria.[1434] At the same time, as discussed below, substituted compliance does not require that there be requirement-by-requirement comparability between Exchange Act requirements and foreign requirements, as the operative question is whether there is the comparability of the associated regulatory outcomes.[1435]

1432 The business conduct requirements that are the subject of this rulemaking in large part are derived from Exchange Act section 15F(h). As discussed above, however, Exchange Act section 15F(j) imposes on SBS Entities a series of self-executing duties with regard to trade monitoring, risk management systems, regulatory disclosures, information access systems and procedures, conflict-of-interest systems and procedures, and antitrust considerations. Rule 15h-3(h)(2)(iii)(I) requires SBS Entities to adopt written policies and procedures reasonably designed to comply with those duties. See note 605, supra, and accompanying text.

1433 See note 1458, infra, and accompanying text.

1434 See notes 1393 and 1394, supra.

1435 See Section III.B.3.e, infra.

Finally, the Commission is not persuaded by commenter requests that we provide phase-in periods or other means to link the timing of the substantive requirements under the Exchange Act with the availability of substituted compliance.[1436] The effective dates and compliance dates for these business conduct requirements reflect the need to implement those requirements in a timely manner, regardless of whether the alternative route provided by substituted compliance is available.[1437]

ii. Unavailability in Connection with Antifraud Prohibitions and Certain Other Requirements

Paragraph (d)(1) of the final rule provides that substituted compliance is not available in connection with Exchange Act section 15F(h)(4)(A), which in relevant part prohibits SBS Dealers from engaging in fraudulent activities in connection with special entities and more generally. The rule also provides that substituted compliance is not available in connection with Exchange Act rule 15Fh-4(a), which implements that statutory antifraud provision.

In the Commission's view, substituted compliance is not appropriate in connection with those explicit statutory prohibitions of fraudulent conduct, given the central role of the antifraud provisions of the securities laws in protecting the integrity and reputation of U.S. financial markets. The Commission also notes that concerns regarding regulatory duplication do not arise in the context of such antifraud prohibitions in the same way they may arise with respect to other provisions.

1436 See note 1410, supra.

1437 Given the facts and circumstances nature of the substituted compliance assessment, the Commission also does not believe that it would be practicable to provide a standard timeframe for reaching substituted compliance determinations. See note 1415, supra.

Paragraph (d)(1) further provides that substituted compliance is not available in connection with Exchange Act sections 15F(j)(3) and (j)(4)(B). Section 15F(j)(3) requires that SBS Entities disclose, to the Commission and the applicable prudential regulators, information concerning: the terms and conditions of the entity's security-based swaps; security-based swap trading operations, mechanisms and practices; financial integrity protections relating to security-based swaps; and other information relevant to the entity's trading in security-based swaps. Section 15F(j)(4)(B) provides that the SBS Entity upon request shall provide the Commission and any applicable prudential regulator with information necessary to perform statutory functions under Section 15F. In our view, the Commission's oversight of SBS Entities requires that the Commission be able to directly access relevant information from those entities. Accordingly, the Commission does not believe that those requirements that SBS Entities provide information to the Commission are reasonably amenable to being satisfied via compliance with the requirements of a foreign jurisdiction.[1438]

iii. <u>Application to Particular Requirements</u>

It is possible that substituted compliance may be granted with regard to some of these requirements but not others. As discussed below, the Commission intends to assess the comparability of foreign requirements using a holistic approach that focuses on regulatory outcomes rather than predicating substituted compliance on requirement-by-

[1438] In addition, Exchange Act Section 15F(j)(7) authorizes the Commission to prescribe rules governing the duties of SBS Entities. While the Commission is not excluding that provision from the potential availability of substituted compliance, the Commission expects to separately consider whether substituted compliance may be available in connection with any future rules promulgated pursuant to that provision.

requirement similarity.[1439] At the same time, however, the business conduct requirements being adopted today encompass a range of distinct categories (e.g., supervision, counterparty protection, special entity protection) such that those individual categories may be subject to differing conclusions regarding the comparability of regulatory outcomes and/or the associated foreign enforcement and supervisory practices. Thus, for example, it may be possible that the Commission would make substituted compliance available with regard to a particular foreign regulatory regime in connection with certain counterparty protections required by these rules but not the supervision requirements, or vice versa. Ultimately, this would depend on the relevant facts and circumstances, and their impact upon specific assessments of comparability,[1440] and of supervision and enforcement.

The Commission further anticipates that certain categories of the requirements we are adopting today – related to ECP verification, special entities and political contributions – will raise special issues with regard to comparability, and with regard to whether adequate supervision and enforcement is available under the foreign regulatory regime. Such issues are likely to arise with regard to those particular requirements because each of those requirements address protections that may have no foreign law analogues, as those requirements reflect heightened concerns under U.S. law regarding potential abuses involving particular categories of persons. Indeed, those categories and the protections afforded to them under U.S. law may not correspond with any specified

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1439 See Section III.B.3.e, infra.

1440 As discussed below, substituted compliance is predicated on the comparability of regulatory outcomes, and does not mandate rule-by-rule equivalence between specific requirements under Title VII and analogous foreign requirements.

categories of persons or protections under relevant foreign law. As a result, substituted compliance assessments in connection with those categories will require inquiry regarding whether foreign regulatory requirements adequately reflect the same particular interests and protections.

c. Availability to Major SBS Participants

Under the proposed rule, substituted compliance would have been available only to registered SBS Dealers, and would not have been available to registered Major SBS Participants. In taking that proposed position, the Commission noted a lack of information regarding the types of entities that may become Major SBS Participants, and the foreign regulation of those entities.[1441]

Two commenters disagreed with that aspect of the proposal, with one commenter expressing concern regarding major participants being forced to comply with duplicative or potentially conflicting regulatory regimes, and the other commenter suggesting there would be no reason to distinguish between SBS Dealers and Major SBS Participants in this regard.[1442] One commenter, in contrast, opposed the possibility of substituted compliance for Major SBS Participants by citing the lack of relevant information, and stated that the Commission should not consider substituted compliance for Major SBS Participants unless the industry provided data proving that this step would be prudent.[1443]

After further consideration of the issues, the final rule provides that substituted compliance is potentially available in connection with these business conduct

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[1441] See note 1382, supra.

[1442] See note 1412, supra.

[1443] See note 1413, supra.

requirements for registered Major SBS Participants as well as for registered SBS Dealers. This decision reflects the fact that the business conduct standards apply to registered Major SBS Participants as well as to registered SBS Dealers, and recognizes that the market efficiency goals that underpin substituted compliance also can apply when substituted compliance is granted to registered Major SBS Participants.

To implement this approach, the final rule has been revised from the proposal to specify that the Commission may determine that compliance by a registered SBS Dealer and/or by a registered Major SBS Participants – each a "security-based swap entity" under the rule – may satisfy the business conduct requirements through substituted compliance.[1444] The remainder of the final rule refers to a security-based swap "entity" rather than a security-based swap "dealer."

One commenter had expressed the view that more information is needed before substituted compliance is made available to Major SBS Participants.[1445] In the Commission's view, however, those concerns are adequately addressed by the fact that any grant of substituted compliance in connection with the business conduct requirements applicable to Major SBS Participants would be predicated on a determination that the Major SBS Participants is subject to comparable regulation in a foreign jurisdiction. Absent such a determination – and consistent with the Commission's previously noted concerns regarding the need for information regarding the types of entities that may become Major SBS Participants, and the foreign regulation of those entities – the Commission would not grant substituted compliance in connection with registered Major

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1444 See Exchange Act rule 3a71-6(a)(1).

1445 See note 1413, supra, and accompanying text.

SBS Participants, even if the Commission were to grant substituted compliance in connection with registered SBS Dealers in the same jurisdiction.

d. Availability of Substituted Compliance with Regard to U.S. and Foreign Entities, Counterparties and Activity

Under the final rule, substituted compliance in connection with the business conduct requirements is not available to entities that are U.S. persons.[1446] On the other hand, entities that are not U.S. persons may rely on substituted compliance to satisfy the business conduct requirements with regard to the entirety of their security-based swap business, regardless of whether their counterparty for a particular transaction is a U.S. person, or whether any of the associated activity occurs in the U.S.

i. No Availability to U.S. Security-Based Swap Dealers or U.S. Major Security-Based Swap Participants

Consistent with the proposal, the final rule does not make substituted compliance available to U.S. security-based swap dealers or U.S. major security-based swap participants in connection with these business conduct requirements.

Certain commenters had suggested that substituted compliance for these dealer requirements should be available to foreign branches of U.S. persons,[1447] or to U.S. persons in certain circumstances in connection with transaction-level requirements.[1448] One commenter further expressed the view that foreign branches of U.S. banks may be subject to extensive host country supervision, and that concerns regarding duplicative or

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1446 See Exchange Act rule 3a71-6(d). For these purposes, the term "U.S. person" has the meaning set forth in Exchange Act rule 3a71-3(a)(4).

1447 See note 1386, supra.

1448 See notes 1388 and 1389, supra.

inconsistent regulation may arise in connection with the security-based swap activities of U.S. entities. Conversely, one commenter argued that such an extension of the proposed scope of substituted compliance would be inconsistent with the application of U.S. law.[1449]

The Commission concludes on balance that it is appropriate to limit the availability of substituted compliance such that only entities that are not U.S. persons may take advantage of that alternative route for satisfying the Title VII business conduct requirements. In part, this conclusion accounts for the fact that concerns regarding duplication and inconsistency in connection with transaction-level business conduct requirements should be mitigated by the amendment we are adopting to Exchange Act rule 3a71-3, to provide an exception from the business conduct requirements under Exchange Act section 15F(h) – other than supervision requirements pursuant to Exchange Act section 15F(h)(1)(B) – for registered U.S. SBS Dealers in connection with foreign business conducted through their foreign branches.[1450]

The Commission recognizes that the above exception would not mitigate the possibility that U.S. entities may face duplication or inconsistency in certain circumstances. For example, for non-U.S. business that U.S. SBS Dealers and U.S.

1449 See note 1387, supra.

1450 See Exchange Act rule 3a71-3(c); see also Section III.A.3.b, supra. There is a similar exception from the section 15F(h) business conduct requirements (other than supervision) for registered U.S. Major SBS Participants with respect to security-based swap transactions that constitute transactions through a foreign branch of the registered U.S. Major SBS Participant, that are either with a non-U.S. person or with a U.S.-person counterparty that constitutes a transaction conducted through a foreign branch of that counterparty. See Exchange Act rule 3a67-10(d)(2). These exceptions are not available in connection with the CCO requirements, which are promulgated pursuant to Exchange Act section 15F(k).

Major SBS Participants conduct through their foreign branches, such duplication or inconsistency may still arise in connection with the entity-level supervision and CCO regulations being adopted today. For the other security-based swap business of those U.S. SBS Entities, such duplication or inconsistency potentially may arise in connection with any of the business conduct requirements being adopted today.

The Commission nonetheless believes that substituted compliance should not be available to registered entities that are U.S. persons. This conclusion reflects a number of policy considerations. Fundamentally, this approach acknowledges that dealers and major participants that fall within the "U.S. person" definition have a heightened connection to the U.S. market.[1451] As a result of that heightened connection, it is the

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[1451] The definition of "U.S. person" is designed to encompass persons that have a significant portion of their financial and legal relationships within the U.S. "[T]he definition of 'U.S. person' in [17 CFR 240.3a71-3] is intended, in part, to identify those persons for whom it is reasonable to infer that a significant portion of their financial and legal relationships are likely to exist within the United States and that it is therefore reasonable to conclude that risk arising from their security-based swap activities could manifest itself within the United States, regardless of the location of their counterparties, given the ongoing nature of the obligations that result from security-based swap transactions." "Application of 'Security-Based Swap Dealer' and 'Major Security-Based Swap Participant' Definitions to Cross-Border Security-Based Swap Activities," Exchange Act Release No. 72472 (Jun. 25, 2014), 79 FR 47278, 47289 (Aug. 12, 2014) ("SBS Entity Definitions Adopting Release").

Moreover, the definition of "U.S. person" does not carve out the foreign branches of U.S. persons. In part this reflects the fact that "a person does not hold itself out as a security-based swap dealer as anything other than a single person even when it enters into transactions through its foreign branch or office." See id..

Based on the direct nature of this link between the U.S. market and those persons that fall within the "U.S. person" definition, Title VII applies to the security-based swap activities of U.S. persons in a manner that is more comprehensive than its application to the activities of other persons. See generally id. at 47288-91 (addressing how dealer and major participant definitions account for all security-based swap activity of U.S. persons because all such activity occurs in the U.S., but account for a more limited subset of the activity of foreign entities).

Commission's judgment that a U.S. SBS Entity's compliance with the business conduct requirements of Title VII, and the Commission's associated oversight of that entity's security-based swap business, should occur without the potential availability of substituted compliance. Although substituted compliance is predicated on there being comparability with Title VII requirements, and does not exempt or otherwise excuse compliance with Title VII, in the Commission's view direct compliance with the Title VII business conduct requirements by U.S. SBS Entities will efficiently facilitate the Commission's regulatory oversight of entities that have a heightened connection to the U.S. market. That warrants such limits to substituted compliance in our view, notwithstanding the general considerations that support the availability of substituted compliance in connection with the business conduct requirements.

This conclusion also reflects our view that U.S. market participants generally would have a reasonable expectation that the business conduct requirements of Title VII would apply directly, and that the activities of such U.S. persons would be subject to Commission oversight with a degree of directness that may not be present in connection with substituted compliance.

ii. Availability in Connection with U.S. Counterparties and U.S. Activity

Consistent with the proposal, the final rule does not contain any provisions that would limit the ability of foreign registered entities to use substituted compliance to satisfy the business conduct requirements in connection with transactions involving U.S. counterparties or U.S. activity.

One commenter had expressed the view that substituted compliance should not be available in connection with activities involving U.S. persons or U.S. activity, arguing

that the security-based swap activity of U.S. persons directly and immediately impacts the U.S., and would endanger U.S. taxpayers if improperly regulated.[1452] We concur with that commenter regarding the need for proper regulation of SBS Entities in connection with their security-based swap business involving U.S. counterparties and activity (as well as more generally). At the same time, however, we note that substituted compliance is not an alternative to rigorous regulation, but instead is predicated on there being business conduct regulation comparable with the rules we are adopting today. So long as the Commission determines that corresponding foreign requirements are comparable with those Title VII business conduct requirements, the use of substituted compliance accordingly would uphold the interests associated with those Title VII requirements.

Also, following alternative approaches – such as an approach whereby substituted compliance would not be available to a foreign SBS Entity in connection with transactions involving U.S. counterparties or U.S. activity, but would be available in connection with other transactions – in practice may have the effect of forcing the foreign SBS Entity to choose between modifying its business conduct systems, including its supervisory and CCO arrangements to reflect the requirements of U.S. rules, or else exiting the U.S. market and thereby generally reducing competition and market efficiency.[1453]

1452 See note 1390, supra.

1453 Other alternative approaches for addressing the application of substituted compliance could be, for example, to permit substituted compliance in connection with U.S. activity that does not involve U.S. counterparties, or allowing substituted compliance for transaction with U.S. counterparties only so long as no U.S. activity is involved. Reducing the availability of substituted compliance in such a manner, however, would be expected to be accompanied by a

e. Comparability Criteria

As discussed in the Cross-Border Proposing Release, the Commission will endeavor to take a holistic approach in considering whether regulatory requirements are comparable for purposes of substituted compliance, and will focus on the comparability of regulatory outcomes rather than predicating substituted compliance on requirement-by-requirement similarity. The Commission also continues to recognize that foreign regulatory systems differ in their approaches to achieving particular regulatory outcomes, and that foreign requirements that differ from those adopted by the Commission nonetheless may achieve regulatory outcomes comparable with those of Title VII. The Commission further continues to recognize that different regulatory systems may be able to achieve some or all of those regulatory outcomes by using more or fewer specific requirements than the Commission, and that in assessing comparability the Commission may need to take into account the manner in which other regulatory systems are informed by business and market practices in those jurisdictions.[1454]

Accordingly, in considering whether the requirements of a foreign regulatory regime are comparable with the various categories of requirements being adopted today (such as the supervision and counterparty protection requirements we are adopting) the Commission will evaluate whether the foreign requirements provide for regulatory outcomes that are consistent with the regulatory outcomes of the applicable category of requirements. Moreover, as noted above, in application the Commission may determine

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corresponding reduction to the competition and market efficiency benefits associated with substituted compliance.

[1454] See Cross-Border Proposing Release, 78 FR at 31085-86, supra note 6.

that for a particular jurisdiction, the prerequisites for substituted compliance have been met in connection with certain categories of requirements but not others.

In reaching this conclusion, the Commission notes that certain commenters opposed the proposed holistic approach toward assessing comparability based on regulatory outcomes, and that instead expressed the views that any assessments should be done on a requirement-by-requirement basis. Those views at least in part reflected the reasoning that an outcomes-based approach would be subjective and would lead to a "hypothesized similarity in outcomes for sets of rules that are quite different in substance."[1455] In this regard, the Commission recognizes that a requirement-by-requirement approach would be easier to implement and simpler to translate into objective criteria than an alternative approach that focuses on regulatory outcomes. Such a requirement-by-requirement approach, however, could foreclose any grants of substituted compliance, because even highly similar regulatory regimes are likely to have technical differences in the implementing rules. More generally, the Commission believes that the proper focus for analyzing substituted compliance should address regulatory outcomes, because a standard that turns upon the comparability of regulatory outcomes can promote regulatory efficiency in a way that preserves the key protections associated with the business conduct rules, and in a manner that reflects the cross-border nature of the market and helps to curb fragmentation, while facilitating the ability of U.S. persons to participate in the global security-based swap market.[1456]

1455 See note 1391, supra.

1456 A requirement-by-requirement standard, in contrast, similarly would promote key protections, but would not adequately address the cross-border nature of the market and the ability of U.S. persons to participate in the global market.

As noted above, the Commission foresees that there will be difficult questions connected with comparability assessments for Dodd-Frank requirements related to ECP verification, special entities and political contributions, given that those particular requirements all address activities involving certain classes of U.S. persons, and reflect heightened concerns regarding potential abuses involving such persons.[1457] Recognizing that the comparability assessments will focus on regulatory outcomes rather than rule-by-rule comparisons, the assessments will require inquiry regarding whether foreign regulatory requirements adequately reflect those particular interests and protections.

Moreover, paragraph (d) of the final rule (which as discussed above has been added to the rule to specify the requirements for which substituted compliance potentially is available), provides that prior to making these substituted compliance determinations, the Commission intends to consider whether the information required to be provided to counterparties pursuant to the requirements of the foreign jurisdiction, the counterparty protections of the foreign jurisdiction, the mandates for supervisory systems under the requirements of the foreign jurisdiction, the duties imposed by the foreign jurisdiction, and the CCO requirements of the foreign jurisdiction, are comparable to the Exchange Act requirements.[1458] Those provisions have been included as part of new paragraph (d) in response to commenters to the Cross-Border Proposing Release that requested specific guidance regarding the criteria the Commission will consider in making comparability

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1457 See Section III.B.3.b.iii, supra.

1458 See Exchange Act rule 3a71-6(d)(1). The rule further provides that prior to making a substituted compliance determination in connection with the CCO requirements of section 15F(k), the Commission intends to consider whether the requirements of the foreign jurisdiction regarding CCO requirements are comparable to those required pursuant to the applicable Exchange Act requirements. See Exchange Act rule 3a71-6(d)(2).

assessments,[1459] or that challenged the rule's lack of particularized elements for assessing comparability.[1460] While recognizing those commenters' wish for additional guidance to assist in making applications for substituted compliance, and for assessment criteria that are as specific and objective as possible, in this circumstance the Commission believes that the comparability assessments will turn upon relevant facts and circumstances in a manner such that it would not be practicable to include more specific criteria in the rule.

One commenter questioned how the Commission would be notified of material changes to foreign law that underpins a substituted compliance determination.[1461] The Commission expects to address those issues in connection with considering specific applications for substituted compliance, and notes that, potentially, the requirement that the Commission be notified of material changes in foreign law could be incorporated as conditions to substituted compliance orders, or as part of memoranda of understanding or other arrangements between the Commission and the relevant foreign financial regulators.[1462]

1459 See note 1393, supra.

1460 See note 1394, supra.

1461 See note 1395, supra.

1462 Substituted compliance orders further may be conditioned on security-based swap dealers and major security-based swap participants that rely on substituted compliance notifying the Commission of that reliance. In that respect, the forms that the Commission has adopted for use by applicants for registration as security-based swap dealers or major security-based swap participants provides for applicants to notify the Commission regarding intended reliance on substituted compliance. See Registration Adopting Release, 80 FR at 49049, supra note 989 (questions 3A, B and C of Form SBSE-A, addressing potential reliance on substituted compliance determinations).

Commenters also expressed the views that regulatory comparisons should focus on common principles associated with shared G-20 Leaders goals,[1463] urged the need for consistency and coordination with the work of other regulators and IOSCO,[1464] and with the CFTC,[1465] and also supported building on existing cooperative initiatives,[1466] and supported deference to non-U.S. oversight when possible.[1467] While the Commission intends to be mindful of those various goals and principles as part of its comparability analyses, the decision whether to grant substituted compliance ultimately must focus on whether a foreign regime produces regulatory outcomes consistent with the applicable provisions of the Exchange Act. That type of assessment necessarily must focus on Exchange Act requirements.

Finally, one commenter argued that to help manage operational complexities, the entirety of a regulatory regime should be deemed comparable with the Exchange Act requirements if a significant portion of that regime is found to be comparable.[1468] In the Commission's view, however, such an approach would be inconsistent with the predicate for substituted compliance that there be the comparability of regulatory outcomes. If a foreign regulatory regime does not achieve a regulatory outcome that is comparable to the regulatory outcome associated with particular Exchange Act requirements, then the basis for substituted compliance will not have been satisfied. In that case, substituted

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1463 See note 1396, supra.

1464 See note 1397, supra.

1465 See note 1399, supra.

1466 See note 1398, supra.

1467 See note 1407, supra.

1468 See note 1400, supra.

compliance would not be appropriate with regard to such requirements, notwithstanding its potential availability in connection with other requirements.

f. Consideration of Supervision and Enforcement Practices

Assessment of a foreign regulatory regime's supervisory and enforcement practices is expected to be a critical component of any Commission decision to permit substituted compliance. As discussed in the Cross-Border Proposing Release, when the Commission assesses a foreign regulatory regime's oversight for purposes of making a substituted compliance determination, the Commission expects to consider not only overall oversight activities, but also oversight specifically directed at conduct and activity that would be relevant to the substituted compliance determination.[1469] For example, it would be difficult for the Commission to make a comparability determination in support of substituted compliance if oversight is directed solely at the local activities of foreign security-based swap dealers, as opposed to the cross-border activities of such dealers.

In making this consideration a prerequisite for substituted compliance, the Commission in no way should be interpreted as minimizing the significance of the Commission's own independent obligation to supervise the compliance of registered entities with Title VII requirements, even when requirements may be satisfied via substituted compliance. Registered entities are subject to the requirements of Title VII, and the Commission retains its full authority to inspect, examine and supervise those entities' compliance with Title VII, and take enforcement action as appropriate, regardless of the availability of substituted compliance.

[1469] See Cross-Border Proposing Release, 78 FR at 31088 n.1117, supra note 6.

One comment emphasized that the assessment must address a foreign regulatory regime's supervisory and enforcement capabilities in practice, not merely on paper.[1470] Another comment stated that differences among the supervisory and enforcement regimes should not be assumed to reflect flaws in one regime or another.[1471] The Commission expects that its consideration of the effectiveness of a foreign regulatory regime's practices will account for those factors in conjunction with other relevant factors.[1472]

Applying those principles here, the Commission notes that the difficult questions noted above with respect to requirements regarding ECP verification, special entities and political contributions also can be expected to manifest themselves in connection with our consideration of a foreign regulatory regime's supervisory and enforcement practices. That is, as the Commission evaluates the foreign regulatory regime's supervisory and enforcement practices in connection with substituted compliance, the Commission necessarily will seek to evaluate whether those supervisory and enforcement practices will adequately support regulatory outcomes consistent with those particular requirements (as well as the other business conduct requirements).

More generally, the scope of any grant of substituted compliance may be linked to the scope of foreign regulatory regime's supervision and enforcement practices. For

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1470 See note 1401, supra.

1471 See note 1402, supra.

1472 In this regard, the Commission notes that one commenter requested further guidance regarding the Commission's consideration of the effectiveness of foreign supervision and enforcement. See note 1403, supra. In the Commission's view, however, consideration of foreign supervisory and enforcement effectiveness will turn upon relevant facts and circumstances in a manner such that it would not be practicable to provide more specific guidance regarding specific factors that may be included within that analysis.

example, if a foreign regulatory regime closely oversees the security-based swap business that an SBS Entity conducts through an office located in that non-U.S. jurisdiction, but does not exercise the same degree of regulatory oversight over a branch of that entity that is located in the U.S., it is possible that any grant of substituted compliance would not extend to activities conducted through the entity's U.S. branch.

g. Multi-Jurisdictional Issues

Commenters further have raised certain issues – that were not addressed in the Cross-Border Proposing Release – regarding how the substituted compliance rule would apply to certain special circumstances involving multi-jurisdictional activities of foreign security-based swap dealers. While recognizing the facts-and-circumstances nature of the application of substituted compliance under the final rule, the Commission anticipates that the final rule would apply generally to such circumstances in the following manner:

i. Third-Country Branches

One commenter particularly raised questions regarding the application of substituted compliance in connection with third-country branches of foreign security-based swap dealers, and requested further guidance regarding how substituted compliance would apply to circumstances where an entity located in one country has a branch located in another country that engages in dealing activity.[1473] The potential availability of substituted compliance under the final rule will reflect the scope of any relevant substituted compliance order, including, for instance, whether an order for a particular jurisdiction extends to third-country branches of entities domiciled within that jurisdiction. The scope of any such order – and hence the potential availability of

[1473] See note 1404, supra.

substituted compliance for a third-country branch – necessarily will turn upon the applicable facts and circumstances.

ii. Substituted Compliance and the European Union

Commenters also raised issues regarding the assessment of substituted compliance in the context of the European Union, stating that certain rules are adopted at a European level and are applied directly by individual member states.[1474] In the Commission's view, such issues may be expected to affect analyses of substantive comparability in a manner that differs from the way they may apply to consideration of the adequacy of a foreign regulatory regime's enforcement and supervisory system. In particular, to the extent that substantive requirements are promulgated at a multi-state level, the Commission's analysis may consider whether those multi-state requirements are comparable to the corresponding Exchange Act requirements. In contrast, to the extent that the enforcement and supervision of those requirements is conducted at the member state level, then the Commission necessarily would assess the adequacy of a foreign regulatory regime's enforcement and supervisory system at the member state level. Any grant of substituted compliance necessarily would take into account both the substantive requirements and the adequacy of the relevant enforcement and supervisory system.

iii. Additional Cross-Jurisdictional Issues

Another commenter raised issues regarding which sets of requirements would apply to transactions between parties in different markets, and whether the parties to

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[1474] See note 1406, supra.

cross-jurisdiction transactions may choose which rules apply.[1475] As discussed above, substituted compliance is intended to help promote efficiency, enhance competition and facilitate a well-functioning market by helping SBS Entities avoid regulatory conflicts or duplication. Substituted compliance is not mandatory, moreover, so when it is available a non-U.S. SBS Entity may elect whether to rely on comparable foreign requirements with regard to its security-based swap business or some discrete portion of that business. However, the policies and procedures of non-U.S. SBS Entities generally should address with particularity when the entity will rely on substituted compliance with regard to particular requirements (e.g., with regard to particular portions of their security-based swap business and/or particular counterparties).

h. Applications for Substituted Compliance and Related Prerequisites

Paragraph (c)(1) of the final rule provides that a party or group of parties that potentially would rely on substituted compliance, or any foreign financial regulatory authority or authorities supervising such a party or its security-based swap activities, may file an application, pursuant to the procedures set forth in Exchange Act Rule 0-13 requesting that the Commission make a substituted compliance determination.[1476] Exchange Act Rule 0-13 is a procedural rule that the Commission has adopted regarding the submission of substituted compliance applications, and provides for the opportunity

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1475 See note 1405, supra.

1476 See Exchange Act rule 3a71-6(c)(1). The final rule accordingly provides that a foreign financial regulatory authority may submit a substituted compliance application if that authority supervises a party that would rely on substituted compliance, or supervises that party's activities. A regulatory authority that does not possess such supervisory responsibilities would not be eligible to submit a substituted compliance application, even if that authority promulgates rules or other requirements applicable to such parties' security-based swap activities.

for public comment on completed applications.[1477] Paragraph (c)(1) has been revised from the proposal (which only referred to applications by security-based swap dealers) to reflect the fact that Rule 0-13 provides for applications by foreign financial authorities.[1478] Also, to avoid duplicating the requirements of Rule 0-13, paragraph (c)(1) also has been revised from the proposal by removing references to the need for the applicant to provide the reasons for the request and provide supporting documentation as the Commission may request.

In addition, paragraph (c)(1) has been revised from the proposal to provide that applications may be made by parties or groups of parties that potentially would rely on substituted compliance, in lieu of the proposed reference to applications by foreign security-based swap dealers or groups of dealers "of the same class." This change in part accommodates the possibility that market participants may seek approval to rely on substituted compliance prior to their being deemed to be "security-based swap dealers" or "major security-based swap participants" under the applicable definitions. The final rule also does not limit joint applications to those that come from persons "of the same class,"

1477 Among other respects, Rule 0-13 provides that applications must include any supporting documents necessary to make the application complete, "including information regarding applicable requirements established by the foreign financial regulatory authority or authorities, as well as the methods used by the foreign financial regulatory authority or authorities to monitor and enforce compliance with such rules." Rule 0-13 further provides that Commission staff will review the application after the filing is complete, and that completed applications will be published for public comment.

1478 See Cross-Border Adopting Release, 79 FR at 47358, supra note 193 (concluding, in adopting Rule 0-13, that "allowing foreign regulators to submit such requests would promote the completeness of requests and promote efficiency in the process for considering such requests").

to facilitate the Commission's ability to consider applications jointly submitted by multiple entities notwithstanding differences in their businesses.[1479]

In connection with applications submitted by such parties, Rule 3a71-6(c)(2)(i) states that such a party (or group of parties) may make a substituted compliance request only if the party or the party's activities are "directly supervised by the foreign financial regulatory authority or authorities with respect to the foreign regulatory requirements relating to the applicable requirements."[1480] This condition should help promote the principles that condition substituted compliance on the effectiveness of the supervision and enforcement exercised by the foreign authority, by reflecting the fact that substituted compliance will not be allowed for entities that are not subject to foreign oversight in connection with their security-based swap business.

The final rule further provides that to make a request for substituted compliance, each such party must provide the certification and opinion of counsel that is described in Exchange Act rule 15Fb2-4(c), as if the party were subject to that requirement at the time of the request.[1481] Rule 15Fb2-4(c) requires that nonresident security-based swap dealers and major security-based swap participants must certify, and provide an associated

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1479 Paragraphs (c)(1) and (c)(2) also have been changed to reflect the possibility that the foreign regulators may supervise the party, or the party's activities.

1480 See Exchange Act rule 3a71-6(c)(2)(i). This provision has been changed from the proposal to reflect the fact that potential applicants will not be limited to security-based swap dealers. This provision also has been changed from the proposal by removing a redundant reference to the foreign authorities being "under the system." In addition, the introductory part of paragraph (c)(2) has been modified from the proposal to refer to requests made "pursuant to paragraph (c)(1)" (rather than "pursuant to paragraph (a)(1)" as set forth in the proposal), consistent with the revised structure of the rule.

1481 See Exchange Act rule 3a71-6(c)(2)(ii).

opinion of counsel, that the entity can as a matter of law, and will, provide the Commission with prompt access to the entity's books and records and submit to onsite inspection and examination by the Commission.[1482] This part of the final rule is generally consistent with the proposal, with one change to permit an entity to apply for substituted compliance before the entity registers with the Commission.[1483]

The final rule also has been revised from the proposal to implement an analogous requirement in connection with substituted compliance applications by foreign financial regulatory authorities.[1484] In particular, the final rule provides that foreign financial regulatory authorities may make substituted compliance requests only if each such

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1482 See Exchange Act rule 15Fb2-4(c). Under that rule, the certification must state that the entity "can, as a matter of law, and will" provide such access to the Commission, while the opinion of counsel only says that the entity "can, as a matter of law" provide such a certification.

As noted, although commenters to the Cross-Border Proposing Release had questioned such direct access on deference-related grounds, the Commission subsequently adopted a final rule requiring those certifications and opinions of counsel as prerequisites to registration by nonresident entities. See notes 1408 and 1409, supra. In adopting that prerequisite, we noted our belief that "significant elements of an effective regulatory regime are the Commission's abilities to access registered SBS Entities' books and records and to inspect and examine the operations of registered SBS Entities." See Registration Adopting Release, 80 FR at 48981, supra note 989.

1483 The final rule, in contrast to the proposal, states that the party must provide the certification and opinion of counsel "as if the party were subject to that requirement at the time of the request." Because the requirements of rule 15Fb2-4(c) are imposed on an entity applying for registration with the Commission, the addition of that language should facilitate the ability of an entity to apply for substituted compliance before the entity is required to register with the Commission as a security-based swap dealer or as a major security-based swap participant.

1484 See Exchange Act rule 3a71-6(c)(3). As noted above, the final rule has been modified from the proposal to permit foreign financial regulatory authorities to submit substituted compliance applications, necessitating the addition of this prerequisite to applications by such authorities.

authority provides adequate assurances that no law or policy of any relevant foreign jurisdiction would impede the ability of any entity that is directly supervised by the foreign financial regulatory authority, and that may register with the Commission as a security-based swap dealer or major security-based swap participant, to provide prompt access to the Commission to such entity's books and records or to submit to onsite inspection or examination by the Commission.[1485]

In general, those prerequisites to the submission of substituted compliance applications by entities or by foreign financial authorities should promote efficiency in the substituted compliance assessment process. The prerequisites particularly will help focus such assessments upon those jurisdictions that would not effectively prohibit entities from registering as dealers or major participants as a result of blocking statutes or other laws or policies that otherwise would impede the Commission's ability to exercise its supervisory authority and responsibilities over registered entities. In other words, if a jurisdiction has blocking statutes or other laws or policies that would preclude the registration of such dealers and major participants with the Commission, there would be no purpose to the Commission considering a substituted compliance application in connection with that jurisdiction.

Exchange Act rule 0-13, which addresses the submission of substituted compliance applications, states that the Commission will not consider hypothetical

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[1485] While applications by foreign financial regulatory authorities must include such adequate assurances, the rule does not specifically require those applications to be accompanied by opinions of counsel (in contrast to applications submitted by entities that seek to rely on substituted compliance). Opinions of counsel, however, provide one possible way in which such authorities may provide the necessary adequate assurances.

requests for substituted compliance orders.[1486] Consistent with that limitation, when the Commission reviews substituted compliance applications, it would take into account whether particular jurisdictions contain entities that reasonably may be expected to register with the Commission as security-based swap dealers or major security-based swap participants based on their level of security-based swap activity connected with U.S. persons or the U.S. market.

IV. Explanation of Dates

A. Effective Date

These final rules will be effective 60 days following publication in the Federal Register.

B. Compliance Date

The Commission believes it appropriate not to apply these rules until entities are required to register as SBS Dealers or Major SBS Participants. Therefore, with the exception of the application of customer protection requirements described in final Rule 3a71-3(c) to transactions described under final Rule 3a71-3(a)(8)(i)(B), the Commission is adopting a compliance date for final Rules 15Fh-1 through 15Fh-6[1487] and Rule 15Fk-1 that is the same as the compliance date of the SBS Entity registration rules ("Registration Compliance Date").[1488]

1486 See Exchange Act rule 0-13(e).

1487 See Section II.H.9 (Certain Political Contributions by SBS Dealers), supra, discussing, among other things, how Rule 15Fh-6 applies to contributions made before the SBS Dealer registered with the Commission as such as well as how the rule's "look back" provision will not apply to contributions made before the compliance date of the rule by newly covered associates to which the look back applies.

1488 See Registration Adopting Release, supra note 989.

In the Registration Adopting Release, the Commission provided that the Registration Compliance Date will be the later of: six months after the date of publication in the Federal Register of final rules establishing capital, margin and segregation requirements for SBS Entities;[1489] the compliance date of final rules establishing recordkeeping and reporting requirements for SBS Entities;[1490] the compliance date of final rules establishing business conduct requirements under Sections 15F(h) and 15F(k) of the Exchange Act; or the compliance date for final rules establishing a process for a registered SBS Entity to make an application to the Commission to allow an associated person who is subject to a statutory disqualification to effect or be involved in effecting security-based swaps on the SBS Entity's behalf.[1491]

The Commission has previously noted the potential complexities associated with identifying transactions of a dealer that it arranges, negotiates, or executes by personnel located in the United States under Rule 3a71-3(b)(1)(iii)(C),[1492] which requires a non-U.S.-person dealer to include such transactions in its de minimis threshold calculations. In the U.S. Activity Adopting Release, the Commission specified that the compliance date for that rule is "the later of (a) 12 months following publication in the Federal

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1489 The Commission previously has proposed rules to establish capital, margin and segregation requirements for SBS Entities. See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, Exchange Act Release No. 68071 (Oct. 18, 2012), 77 FR 70213 (Nov. 23, 2012).

1490 The Commission previously has proposed rules to establish recordkeeping and reporting requirements for SBS Entities. See Recordkeeping Release, 79 FR 25193, supra note 242.

1491 See Registration Adopting Release, supra note 989.

1492 See U.S. Activity Adopting Release, 81 FR 8636-37.

Register, or (b) the SBS Entity Counting Date."[1493] Because the Commission believes similar potential complexities exist with respect to such transactions that are included in "U.S. business" as defined in final Rule 3a71-3(a)(8)(i)(B), the Commission is adopting a compliance date for application of customer protection requirements described in final Rule 3a71-3(c) to transactions described under final Rule 3a71-3(a)(8)(i)(B) that is the later of (a) 12 months following publication in the Federal Register, or (b) the Registration Compliance Date.

The Commission believes that these timing requirements should provide firms with adequate time to review the business conduct rules being adopted today and make appropriate business decisions before being required to comply with the requirements of the rules.

C. Application to Substituted Compliance

For the substituted compliance provisions of Rule 3a71-6, the Commission similarly is adopting an effective date of 60 days following publication in the Federal Register. There will be no separate compliance date in connection with that rule, as the rule does not impose obligations upon entities separate and apart from the underlying business conduct requirements. As discussed above, security-based swap dealers and major security-based swap participants will not be required to comply with the business conduct requirements until they are registered, and the registration requirement for those entities will not be triggered until a number of regulatory benchmarks have been met.

In practice, the Commission recognizes that if the requirements of a foreign regime are comparable to Title VII requirements, and the other prerequisites to

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1493 Id.

substituted compliance also have been satisfied, then it may be appropriate to permit a security-based swap dealer or major security-based swap participant to rely on substituted compliance commencing at the time that entity is registered with the Commission. Accordingly, the Commission would consider substituted compliance requests that are submitted prior to the compliance date for the entity registration requirements.

V. Paperwork Reduction Act

Certain provisions of the Rules impose new "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").[1494] In accordance with 44 U.S.C. 3507 and 5 CFR 1320.11, the Commission submitted the provisions to the Office of Management and Budget ("OMB") for review when it issued the Proposing Release. 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."

Compliance with collection of information requirements is mandatory. 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 assigned control number 3235-0732 to the new collections of information.

In the Proposing Release, the Commission requested comment on the collection of information requirements contained therein, as well as the accuracy of the Commission's related estimates and statements regarding the associated costs and

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[1494] 44 U.S.C. 3501 et seq.

burdens of the proposed rules. As noted above, the Commission received 43 comment letters addressing the Proposing Release, as well as those portions of the Cross-Border Proposing Release that referenced the proposed rules governing business conduct standards for security-based swap dealers. Although none of the comment letters specifically addressed the Commission's estimates for the proposed collection of information requirements, the views of commenters relevant to the Commission's analysis of burdens, costs, and benefits of the proposed rules are discussed in Section IV.C, below.

The Commission continues to believe that the methodology used for calculating the burdens set forth in the Proposing Release is appropriate. However, where noted, certain estimates have been modified, as necessary, to conform to the adopted rules and to reflect the most recent data available to the Commission. Other than these changes, the Commission's estimates remain unchanged from those in the Proposing Release.

As a part of this release, the Commission also is adopting Rule 3a67-10(d) and Rule 3a71-3(c), which among other things, provide an exception to certain of the business conduct standards described in section 15F(h) of the Act, and the rules and regulations thereunder, to registered Major SBS Participants and registered SBS Dealers in certain transactions conducted through the foreign branch of their U.S.-person counterparty. As part of the process of availing themselves of this exception, registered Major SBS Participants (in the case of Rule 3a67-10(d)) and registered SBS Dealers (in the case of Rule 3a71-3(c)) would be permitted to rely on certain representations provided to them by their counterparties regarding whether a transaction is conducted through a foreign branch. The requirements regarding those representations are

contained in Rule 3a71-3(a)(3)(ii). The Commission previously published a notice requesting comment on the collection of information requirements in Rule 3a71-3 as part of the Cross-Border Proposing Release, and submitted those proposed collection of information requirements to OMB for review in accordance with 44 U.S.C. 3507 and 5 CFR 1320.11. The title of the collection of information related to the representation in Rule 3a71-3 is "Reliance on Counterparty Representations Regarding Activity Within the United States." OMB has not yet assigned a control number to this collection.

The Commission also is adopting Rule 3a71-6 to provide for substituted compliance in connection with the business conduct requirements. As proposed, the title of the information collection associated with that rule was "Rule 3a71-5 Substituted Compliance for Foreign Security-Based Swap Dealers."[1495] The OMB assigned control number 3235-0715 to the new collection of information. In the Cross-Border Proposing Release, the Commission solicited comment on the collection of information requirements associated with the substituted compliance rule and on the accuracy of the Commission's related statements. The Commission received no comments on those proposed information collection requirements.

A. Summary of Collections of Information

1. Definitions

Rule 15Fh-2(d) defines a "special entity" as: (1) a Federal agency; (2) a State, State agency, city, county, municipality, other political subdivision of a State, or any

[1495] Consistent with the renumbering of the rule and the potential availability of substituted compliance to Major SBS Participants, the revised title of the collection of information is "Rule 3a71-6 Substituted Compliance for Foreign Security-Based Swap Entities."

instrumentality, department, or a corporation of or established by a State or political subdivision of a State; (3) any employee benefit plan subject to Title I of ERISA; (4) any employee benefit plan defined in Section 3 of ERISA, not otherwise defined as a special entity, unless such employee benefit plan elects not to be a special entity by notifying an SBS dealer or Major SBS Participant of its election prior to entering into a security-based swap; (5) any governmental plan, as defined in Section 3(32) of ERISA; or (6) any endowment, including organizations described in Section 501(c)(3) of the Internal Revenue Code.

The proposed rule included employee benefit plans "defined in" ERISA within the special entity definition. The final rule similarly includes employee benefit plans "defined in" ERISA that are not otherwise "subject to" ERISA within the special entity definition, although it provides such benefit plans with the ability to opt out of special entity status.

2. Verification of Status

Rule 15Fh-3(a)(1) requires an SBS Entity to verify that a counterparty meets the eligibility standards for ECP status before entering into a security-based swap with that counterparty other than with respect to a transaction executed on a registered national securities exchange.

Rule 15Fh-3(a)(2) requires an SBS Entity to verify whether a counterparty is a special entity before entering into a security-based swap transaction with that counterparty, unless the transaction is executed on a registered or exempt SEF or registered national securities exchange, and the SBS Entity does not know the identity of

the counterparty at a reasonably sufficient time prior to the transaction to permit the SBS Entity to comply with the obligations of the rule.

Rule 15Fh-3(a)(3) requires an SBS Entity, in verifying the special entity status of a counterparty pursuant to Rule 15Fh-3(a)(2), to verify whether a counterparty is eligible to elect not to be a special entity as provided for in the adopted special entity definition in Rule 15Fh-2(d)(4), and if so, to notify such counterparty of its right to make such an election. An SBS Entity may satisfy these verification requirements through any reasonable means including, among other things, by obtaining written representations from the counterparty as to specific facts about the counterparty.[1496]

3. Disclosures by SBS Entities

Rule 15Fh-3(b) generally requires an SBS Entity at a reasonably sufficient time prior to entering into a security-based swap to disclose to a counterparty (other than an SBS Entity or Swap Entity) material information concerning the security-based swap in a manner reasonably designed to allow the counterparty to assess: (1) the material risks and characteristics of a particular 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. These disclosure requirements do not apply unless the identity of the counterparty is known to the SBS Entity at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rule. The rule also requires the SBS Entity to make a written record of any non-written disclosures

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[1496] The Commission separately has proposed rules regarding recordkeeping and reporting requirements for SBS Entities that would require an SBS Entity to keep records of its verification. See Recordkeeping Release, 79 FR 25193, 25208 and 25217-25218, supra note 242.

made pursuant to this provision, and timely provide a written version of these disclosures to counterparties no later than the delivery of the trade acknowledgement of the particular transaction.

Rule 15Fh-3(c)(1), for cleared security-based swaps, requires an SBS Entity to, upon request of the counterparty, disclose the daily mark to the counterparty (other than an SBS Entity or Swap Entity). the daily mark that the SBS Entity receives from the appropriate clearing agency. Rule 15Fh-3(c)(2), for uncleared security-based swaps, requires an SBS Entity to disclose the daily mark to the counterparty, which is the midpoint between the bid and offer, or the calculated equivalent thereof, as of the close of business, unless the parties agree in writing to a different time, on each business day during the term of the security-based swap. Rule 15Fh-3(c)(2) also requires disclosure of the data sources and a description of the methodology and assumptions used to prepare the daily mark for an uncleared security-based swap, as well as disclosure of any material changes to such data sources, methodology or assumptions during the term of the security-based swap. Rule 15Fh-3(c)(1) and (2) also require an SBS Entity to provide the daily mark without charge to the counterparty and without restrictions on the internal use of the daily mark by the counterparty.

Rule 15Fh-3(d) requires an SBS Entity to disclose information regarding clearing rights to its counterparties(other than an SBS Entity or Swap Entity), so long as the identity of the counterparty is known to the SBS Entity at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rule. Pursuant to the rule, before entering into a security-based swap that is subject to the clearing requirements of Section 3C(a) of the Exchange Act, the SBS

Entity shall 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 SBS Entity is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap; disclose to the counterparty whether any of the named clearing agencies satisfy the standard for clearing under Section 3C(a)(1) of the Exchange Act; and notify the counterparty that it shall have the sole right to select which clearing agency shall be used to clear the security-based swap. For security-based swaps, not subject to the clearing requirements of Section 3C(a) of the Exchange Act, before entering into a security-based swap, the SBS Entity shall determine whether the security-based swap is accepted for clearing by one or more clearing agencies; disclose to the counterparty the names of the clearing agencies that accept the security-based swap for clearing, 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; and 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 SBS Entity is authorized or permitted, directly or through a designated clearing member, to clear the security-based swap. To the extent that the disclosures required by Rule 15Fh-3(d) are not provided in writing prior to the execution of the transaction, the SBS Entity is required to make a written record of the non-written disclosures and provide the counterparty with a written version of these disclosure no later than the delivery of the trade acknowledgement for the transaction.

4. <u>Know Your Counterparty and Recommendations</u>

Rule 15Fh-3(e) requires an SBS Dealer to establish, maintain and enforce written 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 that are necessary for conducting business with such counterparty. The essential facts are: (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 with transactions entered into with such counterparty; and (3) information regarding the authority of any person acting for such counterparty.

Rule 15Fh-3(f)(1) requires an SBS Dealer recommending a security-based swap or trading strategy involving a security-based swap to a counterparty (other than an SBS Entity or a Swap Entity) to: (i) undertake reasonable diligence to understand the potential risks and rewards associated with the recommendation; and (ii) have a reasonable basis to believe that the recommendation is suitable for the counterparty. To establish a reasonable basis for a recommendation, an SBS 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 involving a security-based swap.

Under Rule 15Fh-3(f)(2), an SBS Dealer may also fulfill its suitability obligations under Rule 15Fh-3(f)(1)(ii) with respect to an institutional counterparty (defined as a counterparty that is an eligible contract participant as defined in clauses (A)(i), (ii), (iii), (iv), (viii), (ix) or (x), or clause (B)(ii) (other than a person described in clause (A)(v)) of Section 1a(18) of the Commodity Exchange Act and the rules and regulations thereunder, or any person (whether a natural person, corporation, partnership, trust or otherwise) with

total assets of at least $50 million) if: (i) the SBS Dealer reasonably determines that the counterparty (or its agent) is capable of independently evaluating the 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 its independent judgment in evaluating the recommendations of the SBS Dealer with regard to the relevant security-based swap or trading strategy; and (iii) 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 for the counterparty. Under Rule 15Fh-3(f)(3), an SBS Dealer will be deemed to have satisfied the requirements of Rule 15Fh-3(f)(2)(i) if it receives written representations, as provided in Rule 15Fh-1(b), that: (i) in the case of a counterparty that is not a special entity, the counterparty has complied in good faith with written policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so; and (ii) in the case of a counterparty that is a special entity, satisfy the terms of the safe harbor in Rule 15Fh-5(b).

5. Fair and Balanced Communications

Rule 15Fh-3(g) requires an SBS Entity to communicate with its counterparties in a fair and balanced manner based on principles of fair dealing and good faith. The rule requires that: (1) communications provide a sound basis for evaluating the facts with regard to a particular security-based swap or trading strategy involving a security-based swap; (2) communications not imply that past performance will recur or make any exaggerated or unwarranted claim, opinion, or forecast; and (3) any statement referring to

potential opportunities or advantages presented by a particular security-based swap be balanced by an equally detailed statement of the corresponding risks.

6. Supervision

Rule 15Fh-3(h) requires an SBS Entity to establish and maintain a system to supervise, and to diligently supervise, its business and the activities of its associated persons. Such a system shall be reasonably designed to prevent violations of the provisions of applicable federal securities laws and the rules and regulations thereunder relating to its business as an SBS Entity. At a minimum, the supervisory system must: (i) designate at least one person with authority to carry out supervisory responsibilities for each type of business in which the SBS Entity engages for which registration as an SBS Entity is required; (ii) use reasonable efforts to determine all such supervisors are qualified, either by virtue of experience or training, to carry out their assigned responsibilities; and (iii) establish, maintain and enforce written policies and procedures addressing the supervision of the types of security-based swap business in which the SBS Entity is engaged and the activities of it associated persons that are reasonably designed to prevent violations of applicable securities laws and rules and regulations thereunder.

Such written policies and procedures must include, at a minimum, procedures: (a) for the review by a supervisor of transactions for which registration as an SBS Entity is required; (b) for the review by a supervisor of incoming and outgoing written (including electronic) correspondence with counterparties or potential counterparties and internal written communications relating to the SBS Entity's security-based swap business; (c) for a periodic review, at least annually, of the security-based swap business in which the SBS Entity engages that is reasonably designed to assist in detecting and preventing violations

of applicable federal securities laws and regulations; (d) to conduct a reasonable investigation regarding the good character, business repute, qualifications, and experience of any person prior to that person's association with the SBS Entity; (e) to consider whether to permit an associated person to establish or maintain a securities or commodities account or a trading relationship in the name of, or for the benefit of, such associated person at another financial institution, and if permitted, to supervise the trading at such institution; (f) describing the supervisory system, including the titles, qualifications and locations of supervisory persons and the responsibilities of each supervisory person with respect to the types of business in which the SBS Entity is engaged; (g) 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; provided that if the SBS Entity determines, with respect to any of its supervisory personnel, that compliance with this requirement is not possible because of the firm's size or a supervisory person's position within the firm, then the SBS Entity must document the factors used to reach such determination and how the supervisory arrangement otherwise complies with this rule, and include a summary of such determination in the annual compliance report prepared by the SBS Entity's CCO pursuant to Rule 15Fk-1(c); (h) reasonably designed to prevent the supervisory system from being compromised due to conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person, the revenue such person generates for the SBS Entity, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised; and (i) reasonably

designed, taking into consideration the nature of the SBS Entity's business, to comply with the duties set forth in Section 15F(j) of the Exchange Act.

Rule 15Fh-3(h)(3) provides that an SBS Entity (or associated person of an SBS Entity) will not be deemed to have failed to diligently supervise another person if that person is not subject to his or her supervision, or if: (i) the SBS Entity has established and maintained written policies and procedures (as required in Rule15Fh-3(h)(2)(iii)), 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 SBS Entity or associated person has reasonably discharged the duties and obligations required by such written policies and procedures and documented system and did not have a reasonable basis to believe that such written policies and procedures and documented system were not being followed.

Rule 15Fh-3(h)(4) provides that an SBS Entity must also promptly amend its written supervisory procedures as appropriate when material changes occur in applicable securities laws, rules, or regulations thereunder, as well as when material changes occur in its business or supervisory system, and promptly communicate any material amendments to its supervisory procedures to all associated person to whom such amendments are relevant based on their activities and responsibilities.

7. SBS Dealers Acting as Advisors to Special Entities

Rule 15Fh-4(b)(1) imposes the duty on an SBS Dealer that acts as an advisor to a special entity regarding a security-based swap to make a reasonable determination that any security-based swap or trading strategy involving a security-based swap

recommended by the SBS Dealer is in the best interests of the special entity. Paragraph (b)(2) also requires an SBS Dealer acting as an advisor to a special entity to make reasonable efforts to obtain such information as it considers necessary to make a reasonable determination that a security-based swap or related trading strategy is in the best interests of the special entity. The information that must be obtained to make this reasonable determination includes, but is not limited to: (i) the authority of the special entity to enter into a security-based swap; (ii) the financial status and future funding needs of the special entity; (iii) the tax status of the special entity; (iv) the hedging, investment, financing or other objectives of the special entity; (v) the experience of the special entity with respect to 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 being recommended. However, the requirements of Rule 15Fh-4(b) do not apply to a security-based swap if: (i) the transaction is executed on a registered or exempt SEF or a registered national securities exchange; and (ii) the SBS Dealer does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the SBS Dealer to comply with the obligations of this rule.

Rule 15Fh-2(a) generally provides that an SBS Dealer acts as an advisor to a special entity when it recommends a security-based swap or security-based swap trading strategy to that special entity. Rule 15Fh-2(a)(1) provides a safe harbor under which an

SBS Dealer will not be deemed to act as an advisor to a special entity that is subject to Title I of ERISA if: (i) the special entity represents in writing that it has a fiduciary as defined in Section 3 of ERISA that is responsible for representing the special entity in connection with the security-based swap; (ii) the fiduciary represents in writing that it acknowledges that the SBS Dealer is not acting as an advisor; and (iii) the special entity represents in writing that (a) it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the special entity receives from the SBS Dealer involving a security-based swap transaction is evaluated by a fiduciary before it is entered into; or (b) that any recommendation the special entity receives from the SBS Dealer involving a security-based swap transaction will be evaluated by a fiduciary before the transaction is entered into.[1497]

Rule 15Fh-2(a)(2) provides a safe harbor for transactions between an SBS Dealer and any special entity. Under this rule, an SBS Dealer that recommends a security-based swap or security-based swap trading strategy to any special entity (other than a special entity subject to Title I of ERISA) will not be deemed to act as an advisor to that special entity if the special entity represents in writing that it acknowledges that the SBS Dealer is not acting as an advisor, and that it will rely on advice from a qualified independent representative, as defined in Rule 15Fh-5(a). The SBS Dealer must also disclose to the special entity that it is not undertaking to act in the best interests of the special entity, as otherwise required by Section 15F(h)(4) of the Exchange Act.[1498]

8. <u>SBS Entities Acting as Counterparties to Special Entities</u>

[1497] Rule 15Fh-2(a)(1)

[1498] Rule 15Fh-2(a)(2)

Rule 15Fh-5(a)(1) requires an SBS Entity that offers to enter into or enters into a security-based swap with a special entity (other than a special entity that is an employee benefit plan subject to Title I of ERISA), to have a reasonable basis to believe that the special entity has a qualified independent representative that meets certain specified qualifications. For purposes of Rule 15Fh-5(a)(1), a qualified independent representative must: (i) have sufficient knowledge to evaluate the transaction and related risks; (ii) not be subject to a statutory disqualification; (iii) undertake a duty to act in the best interests of the special entity; (iv) make appropriate and timely disclosures to the special entity of material information concerning the security-based swap; (iv) evaluate, consistent with any guidelines provided by the special entity, the fair pricing and appropriateness of the security-based swap; (v) in the case of a special entity defined in Rule 15Fh-2(d)(2) or (5), be subject to the pay-to-play prohibitions of the Commission, the CFTC, or a self-regulatory organization that is subject to the jurisdiction of the Commission or the CFTC (unless the independent representative is an employee of the special entity); and (vii) be independent of the SBS Entity that is the counterparty to a proposed security-based swap.[1499]

Rule 15Fh-5(a)(1) also provides that a representative of a special entity will be "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.[1500] In addition, a special entity's representative will be deemed to be "independent" of an SBS Entity if: (1) the

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[1499] Rule 15Fh-5(a)(1)(vii)

[1500] Rule 15Fh-5(a)(1)(vii)(A)

representative is not and was not an associated person of the SBS Entity within one year of representing the special entity in connection with the security-based swap; (2) the representative provides timely disclosures to the special entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the special entity, and complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest; and (3) the SBS Entity did not refer, recommend, or introduce the representative to the special entity within one year of the representative's representation of the special entity in connection with the security-based swap.[1501]

Rule 15Fh-5(a)(2) provides that an SBS Entity that offers to enter into or enters into a security-based swap with a special entity as defined in Rule 15Fh-2(d)(3) (any employee benefit plan that subject to Title I of ERISA) must have a reasonable basis to believe the special entity has a representative that is a fiduciary as defined in Section 3 of ERISA.

Rule 15Fh-5(b) provides safe harbors for SBS Dealers seeking to form a reasonable basis regarding the qualifications of the independent representative. Under Rule 15Fh-5(b)(1), an SBS Entity shall be deemed to have a reasonable basis to believe that a special entity (other than an ERISA special entity) has a representative that satisfies the requirements of Rule 15Fh-5(a)(1) if: (i) the special entity represents in writing to the SBS Entity that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the requirements of Rule 15Fh-5(a)(1), and that such policies and procedures provide for

[1501] Rule 15Fh-5(a)(1)(vii)(B)

ongoing monitoring of the performance of such representative consistent with Rule 15Fh-5(a)(1); and (ii) the representative represents in writing to the special entity and the SBS Entity that the representative: (a) has policies and procedures reasonably designed to ensure that it satisfies the applicable requirements of Rule 15Fh-5(a)(1); (b) meets the independence requirements of Rule 15Fh-5(a)(1)(vii); and (c) is legally obligated to comply with the requirements of Rule 15Fh-5(a)(1) by agreement, condition of employment, law, rule, regulation, or other enforceable duty.

Under Rule 15Fh-5(b)(2), an SBS Entity shall be deemed to have a reasonable basis to believe that an ERISA special entity has a representative that satisfies the requirements of Rule 15Fh-5(a)(2), provided that the special entity provides in writing to the SBS Entity the representative's name and contact information, and represents in writing that the representative is a fiduciary as defined in Section 3 of ERISA.

Under Rule 15Fh-5(c), before initiation of a security-based swap, an SBS Dealer must disclose to the special entity in writing the capacity in which the SBS Dealer is acting in connection with the security-based swap, and, if the SBS Dealer engages in business with the counterparty in more than one capacity, the SBS Dealer must disclose the material differences between such capacities and any other financial transaction or service involving the counterparty to the special entity.

Under Rule 15Fh-5(d), formerly Rule 15Fh-5(c), the provisions of Rule 15Fh-5 do not apply when two conditions are satisfied: (1) the transaction is executed on an registered or exempt SEF or registered national securities exchange; and (2) the SBS Entity is unaware of the counterparty's identity, at a reasonably sufficient time prior to

the execution of the transaction to permit the SBS Entity to comply with the obligations of the rule.

9. Political Contributions

Rule 15Fh-6(b) prohibits an SBS Dealer from offering to enter into, or entering into a security-based swap, or a trading strategy involving a security-based swap, 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. These prohibitions do not apply to certain contributions made by an SBS Dealer's covered associate if the SBS Dealer discovered the contribution within 120 calendar days of the date of such contribution, the contribution did not exceed $350, and the covered associate obtained a return of the contribution within 60 calendar days of the date of discovery of the contribution by the SBS Dealer. However, a SBS dealer may not rely on that provision more than three times in any 12-month period if it has more than 50 covered associated, and no more than twice if it has 50 or fewer covered associates. The Commission may also, upon application, exempt a security-based swap dealer from the prohibitions of the rule after consideration of several factors.

The provisions of Rule 15Fh-6 do not apply when two conditions are satisfied: (1) the transaction is executed on an registered or exempt SEF or registered national securities exchange; and (2) the SBS Dealer is unaware of the counterparty's identity, at a reasonably sufficient time prior to the execution of the transaction to permit the SBS Dealer to comply with the obligations of the rule.

10. Chief Compliance Officer

Rule 15Fk-1 requires an SBS Entity to designate an individual to serve as CCO on its registration form. Under Rule 15Fk-1(b)(1) the CCO must report directly to the board of directors or senior officer of the SBS Entity. Under Rule 15Fk-1(b)(2), the CCO must take reasonable steps to ensure that the SBS Entity establishes, maintains, and reviews written policies and procedures reasonably designed to achieve compliance with the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity by: (1) reviewing the SBS Entity's compliance with the SBS Entity requirements described in Section 15F of the Exchange Act and the rules and regulations thereunder (where such review shall involve preparing the SBS Entity's annual assessment of its written policies and procedures reasonably designed to achieve compliance with Section 15F of the Exchange Act and the rules and regulations thereunder); (2) taking reasonable steps to ensure the SBS Entity establishes, maintains, and reviews policies and procedures reasonably designed to remediate non-compliance issues identified by the CCO through any means, including any compliance office review, look-back, internal or external audit finding, self-reporting to the Commission and other appropriate authorities, or complaint that can be validated; and (3) taking reasonable steps to ensure that the SBS Entity establishes and follows procedures reasonably designed for the handling, management response, remediation, retesting, and resolution of non-compliance issues. Under Rule 15Fk-1(b)(3), the CCO must take reasonable steps to resolve any material conflicts of interest that may arise, in consultation with the board or the senior officer of the SBS Entity. Under Rule 15Fk-1(b)(4), the CCO must administer each policy and procedure that is required to be established pursuant to Section 15F of the Exchange Act and the rules and regulations thereunder.

Under Rule 15Fk-1(c), the CCO must also prepare and sign an annual compliance report that must be submitted to the Commission within 30 days following the deadline for filing the SBS Entity's annual financial report with the Commission pursuant to Section 15F of the Exchange Act and the rules and regulations thereunder. This annual compliance report must contain a description of the written policies and procedures of the SBS Entity described in Rule 15Fk-1(b), outlined above, including the code of ethics and conflict of interest policies. The compliance report must also include, at a minimum, a description of: (1) the SBS Entity's assessment of the effectiveness of its policies and procedures relating to its business as an SBS Entity; (2) any material changes to the policies and procedures since the date of the preceding compliance report; (3) any areas for improvement and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance; (4) any material non-compliance matters identified; and (5) the financial, managerial, operational, and staffing resources set aside for compliance with the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity, including any material deficiencies in such resources. The report must be submitted to the board of directors and audit committee (or equivalent bodies) and the senior officer of the SBS Entity prior to submission to the Commission. The report also must be discussed in one or more meetings (addressing the obligations of this rule) that were conducted by the senior officer with the CCO in the preceding 12 months, and must include a certification by the CCO or senior officer that, to the best of his or her knowledge and reasonable belief and under penalty of law, the information contained in the compliance report is accurate and complete in all material respects.

The final rule allows an SBS Entity to incorporate by reference sections of a compliance report that has been submitted with the current or immediately preceding reporting period to the Commission, and allows an SBS Entity to request from the Commission an extension of time to submit its compliance report, provided that the SBS Entity's failure to timely submit the report could not be eliminated by the SBS Entity without unreasonable effort or expense. Extensions of the deadline will be granted at the discretion of the Commission. The final rule also requires an SBS Entity to promptly submit an amended compliance report if material errors or omissions in the report are identified.

Under Rule 15k-1(d), the compensation and removal of the CCO shall require the approval of a majority of the board of directors of the SBS Entity.

11. Foreign Branch Exception

Rule 3a67-10(d), as adopted, provides that registered major security-based swap participants shall not be subject to business conduct standards described in section 15F(h) of the Act (15 U.S.C. 78o–10(h)), and the rules and regulations thereunder, other than rules and regulations prescribed by the Commission pursuant to section 15F(h)(1)(B) of the Act, in certain transactions conducted through the foreign branch of their U.S.-person counterparty. Rule 3a71-3(c), as adopted, provides a similar exception for registered security-based swap dealers. The previously adopted definition of "transaction conducted through a foreign branch" permits a person to rely on its U.S. bank counterparty's representation that the transaction "was arranged, negotiated, and executed

on behalf of the foreign branch solely by persons located outside the United States, unless such person knows or has reason to know that the representation is not accurate."[1502]

12. Substituted Compliance Rule

Rule 3a71-6, as adopted, provides that the Commission may, conditionally or unconditionally, by order, make a determination with respect to a foreign financial regulatory system that compliance with specified requirements under such foreign financial regulatory system by a registered non-U.S. SBS Entity, or class thereof, may satisfy certain business conduct requirements by complying with the comparable foreign requirements. The availability of substituted compliance would be predicated on a determination by the Commission that the relevant foreign requirements are comparable to the requirements that otherwise would be applicable, taking into account the scope and objectives of the relevant foreign requirements,[1503] and the effectiveness of supervision and enforcement under the foreign regulatory regime.[1504] The availability of substituted compliance further would be predicated on there being a supervisory and enforcement MOU or other arrangement between the Commission and the relevant foreign authority

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1502 See Exchange Act rule 3a71-3(a)(3)(ii).

1503 In the specific context of substituted compliance for the business conduct requirements, prior to making any comparability determination the Commission intends to consider whether the information that is required to be provided to counterparties pursuant to the requirements of the foreign jurisdiction, the counterparty protections under the requirements of the foreign jurisdiction, the mandates for supervisory systems under the requirements of the foreign jurisdiction, and the CCO requirements under the foreign jurisdiction are comparable with the applicable Exchange Act provisions. See Exchange Act Rule 3a71-6(d).

1504 See Exchange Act Rule 3a71-6(a)(2)(i).

addressing supervisory and enforcement cooperation and other matters arising under the substituted compliance determination.[1505]

Requests for substituted compliance may come from parties or groups of parties that may rely on substituted compliance, or from foreign financial authorities supervising such parties or their security-based swap activities.[1506] Under the final rule, the Commission would make any determinations with regard to the applicable business conduct requirements, rather than on a firm-by-firm basis. Once the Commission has made a substituted compliance determination, other similarly situated market participants would be able to rely on that determination to the extent applicable and subject to any corresponding conditions. Accordingly, the Commission expects that requests for a substituted compliance determination would be made only where an entity seeks to rely on particular requirements of a foreign jurisdiction that has not previously been the subject of a substituted compliance request. The Commission believes that this approach would substantially reduce the burden associated with requesting substituted compliance determinations for an entity that relies on a previously issued determination, and, therefore, complying with the Commission's rules and regulations more generally.

As provided by Exchange Act Rule 0-13, which the Commission adopted in 2014, applications for substituted compliance determinations in connection with these requirements must be accompanied by supporting documentation necessary for the Commission to make the determination, including information regarding applicable

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1505 See Exchange Act Rule 3a71-6(a)(2)(ii).

1506 See Exchange Act Rule 3a71-6(c)(1). Such parties or groups of parties may make requests only if each such party or its activities is directly supervised by the foreign financial authority. See Exchange Act Rule 3a71-6(c)(2).

requirements established by the foreign financial regulatory authority or authorities, as well as the methods used by the foreign financial regulatory authority or authorities to monitor and enforce compliance with such rules, and to cite to and discuss applicable precedent.[1507]

B. Use of Information

1. Verification of Status

Rule 15Fh-3(a) requires an SBS Entity to verify that a counterparty meets the eligibility standards for ECP status before offering to enter into or entering into a security-based swap other than with respect to a transaction executed on a registered national securities exchange. The SBS Entity will 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 registered national securities exchange. The rule also requires the SBS Entity to verify, for non-anonymous transactions, whether a counterparty is a special entity before entering into a security-based swap transaction with that counterparty, unless the transaction is executed on a registered or exempt security-based swap execution facility or registered national securities exchange. The SBS Entity will use this information to

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1507 See Exchange Act Rule 0-13(e). Rule 0-13 also specifies other prerequisites for the filing of substituted compliance applications (e.g., requirements regarding the use of English, the use of electronic or paper requests, contact information, and public notice and comment in connection with complete applications).

In adopting Rule 0-13, the Commission also noted that because Rule 0-13 was a procedural rule that did not provide any substituted compliance rights, "collections of information arising from substituted compliance requests, including associated control numbers, [would] be addressed in connection with any applicable substantive rulemakings that provide for substituted compliance." See SBS Entity Definitions Adopting Release, 79 FR at 47366 n.778, supra note 1451.

assess its need to comply with the requirements applicable to dealings with special entities under Rules 15Fh-4(b) and 15Fh-5. In addition, the Commission staff may review this information in connection with examinations and investigations.

2. Disclosures by SBS Entities

The disclosures that SBS Entities must provide to a counterparty (other than an SBS Entity or a Swap Entity) will 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 will assist the counterparty in assessing the transaction by providing them with a better understanding of the expected performance of the security-based swap under various market conditions. The disclosures will also give counterparties additional transparency and insight into the pricing and collateral requirements of security-based swaps.

Rule 15Fh-3(d) requires SBS Entities, before entering into a security-based swap with a counterparty (other than an SBS Entity or Swap Entity), to determine whether the security-based swap is subject to the clearing requirements of Section 3C(a) of the Exchange Act and to disclose its determination to counterparties, along with certain information regarding the clearing alternatives available to them. In addition to assisting the SBS Entity and its CCO in supervising and assessing internal compliance with the statute and rules, the Commission staff may also review this information in connection with examinations and investigations.

3. Know Your Counterparty and Recommendations

These collections of information will help SBS Dealers comply with applicable laws, regulations and rules, as well as assist SBS Dealers in effectively dealing with counterparties. For example, these collections of information may better enable SBS Dealers to make appropriate recommendations for counterparties, and to gather from the counterparty any information that the SBS Dealer needs for credit and risk management purposes. Furthermore, these collections of information will assist SBS Dealers in determining whether it is reasonable to rely on various representations from a counterparty, and in evaluating the risks of trading with that counterparty. The information will also assist a CCO in determining whether the SBS Entity has written policies and procedures reasonably designed to obtain and retain a record of the essential facts concerning each known counterparty, and to make suitable recommendations to its counterparties. The Commission staff may also review this information in connection with examinations and investigations.

4. Fair and Balanced Communications

The collection of information concerning the risks of a security-based swap will assist an SBS Entity in communicating with counterparties in a fair and balanced manner by requiring, among other things, that communications provide a sound basis for evaluating the facts with regard to a particular security-based swap and, if a statement refers to potential opportunities or advantages presented by a particular security-based swap, that statement must be balanced by an equally detailed statement of corresponding risks. It will also help 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 by establishing certain express requirements with which these communications must

comply. Acting on the basis of fair and balanced information, the counterparty will also be better equipped to make more informed investment decisions. The Commission staff may also review this information in connection with examinations and investigations.

5. Supervision

The requirement to establish and maintain a reasonably designed system to supervise, and to diligently supervise, the business and the activities of associated persons will assist an SBS Entity in preventing violations of the applicable securities laws, rules and regulations related to the business of an SBS Entity. The CCO may use this information in discharging his or her duties under Rule 15Fk-1 and in determining whether remediation efforts are required. The collection of information will also be useful to supervisors in understanding and carrying out their supervisory responsibilities. The Commission staff may also review this information in connection with examinations and investigations.

6. SBS Dealers Acting as Advisors to Special Entities

Certain information collected under Rule 15Fh-4(b) will help SBS Dealers that act as advisors to special entities to make a reasonable determination that they are acting in the best interests of those special entities.

Other information collected under Rule 15Fh-2(a) will help SBS Dealers establish that they are not acting as advisors to special entities.

These collections of information will also assist CCOs in determining whether an SBS Dealer has complied with relevant provisions of the Exchange Act, as well as the rules and regulations thereunder. The Commission staff may also review this information in connection with examinations and investigations.

7. SBS Entities Acting as Counterparties to Special Entities

The information collected under Rule 15Fh-5(a) will assist an SBS Entity in forming a reasonable basis to believe that a special entity has a qualified independent representative that meets the requirements of the rule.

The written representations required under Rule 15Fh-5(b) will assist in, and provide a safe harbor for, an SBS Entity forming a reasonable basis as to the qualifications of the independent representative, including representations that: (i) the special entity has complied in good faith with written policies and procedures reasonably designed to ensure its representative satisfies the requirements of Rule 15Fh-5(a)(1), and that such policies and procedures provide for ongoing monitoring of the performance of such representative consistent with Rule 15Fh-5(a)(1); and that (ii) the representative has policies and procedures designed to ensure that it satisfies the requirements of Rule 15Fh-5(a)(1); meets the requirements of Rule 15Fh-5(a)(1)(i), (ii), (iii), (vi) and (vii); and is legally obligated to comply with the requirements of Rule 15Fh-5(a)(1) by agreement, condition of employment, law, rule, regulation, or other enforceable duty.

Disclosures under Rule 15Fh-5(c) regarding the capacity in which an SBS Dealer is acting in connection with a security-based swap will provide additional transparency to special entities as to any material differences between the SBS Dealer's capacities and any other financial transaction or service involving the counterparty to the special entity, such as when an SBS Dealer is acting as a counterparty or principal on the other side of a transaction with potentially adverse interests.

These collections of information will also assist a CCO in assessing the SBS Entity's compliance with relevant provisions of the Exchange Act. The Commission

staff may also review this information in connection with examinations and investigations.

8. Political Contributions

Rule 15Fh-6 will deter SBS Dealers from participating, even indirectly, in pay to play practices. In addition to assisting the SBS Dealer and its CCO in supervising and assessing internal compliance with the pay to play prohibitions, the Commission staff may also review this information in connection with examinations and investigations.

9. Chief Compliance Officer

The information collected under Rule 15Fk-1 will assist the CCO in overseeing and administering an SBS Entity's compliance with the provisions of the Exchange Act and the rules and regulations thereunder relating to its business as an SBS Entity. The Commission staff may also review this information in connection with examinations and investigations.

10. Foreign Branch Exception

Under the final rules, a registered major security-based swap participant or registered security-based swap dealer is not subject to the requirements relating to business conduct standards described in section 15F(h) of the Act (15 U.S.C. 78o-10(h)), and the rules and regulations thereunder, other than the rules and regulations prescribed by the Commission pursuant to section 15F(h)(1)(B) of the Act, in certain transactions conducted through the foreign branch of their U.S.-person counterparty. For these purposes, the foreign branch of a U.S. bank must be the counterparty to the security-

based swap transaction, and the transaction must be arranged, negotiated, and executed on behalf of the foreign branch solely by persons located outside the United States.[1508]

As discussed in the Cross-Border Proposing Release, the Commission acknowledges that verifying whether a security-based swap transaction falls within the definition of "transaction conducted through a foreign branch" could require significant due diligence. The definition's representation provision would mitigate the operational difficulties and costs that otherwise could arise in connection with investigating the activities of a counterparty to ensure compliance with the corresponding rules.[1509]

11. Substituted Compliance Rule

The Commission would use the information collected pursuant to Exchange Act Rule 3a71–6, as adopted, to evaluate requests for substituted compliance with respect to the business conduct requirements applicable to security-based swap entities. The requests for substituted compliance determinations are required when a person seeks a substituted compliance determination.

Consistent with Exchange Act Rule 0-13(h), the Commission will publish in the Federal Register a notice that a complete application has been submitted, and provide the public the opportunity to submit to the Commission any information that relates to the Commission action requested in the application.

C. Respondents

In the Proposing Release, the Commission stated its belief that approximately fifty entities may fit within the definition of SBS Dealer and that up to five entities may

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1508 See Exchange Act rule 3a71-3(a)(3)(i).

1509 See Cross-Border Proposing Release, 78 FR at 31107, supra note 6.

fit within the definition of Major SBS Participant.[1510] Further, the Commission understands swap and security-based swap markets to be integrated, and continues to estimate that approximately thirty-five firms that may register as SBS Entities will also be registered with the CFTC as Swap Entities.[1511] As a result, these entities will also be subject to the business conduct standards applicable to Swap Entities, which the CFTC adopted in 2012. In addition, the Commission continues to estimate that approximately sixteen registered broker-dealers will also register as SBS Dealers.[1512] In the Proposing Release, the Commission estimated that fewer than eight firms not otherwise registered with the CFTC or the Commission would register as SBS Entities. Based on an analysis of updated DTCC data, the Commission now estimates that four registrants would not otherwise be registered with the CFTC or the Commission.[1513]

In the Proposing Release, the Commission estimated that there were approximately 8,500 market participants, including approximately 1,200 special entities in the security-based swap markets.[1514] Based on an analysis of more recent DTCC data and our understanding of security-based swap markets, we currently believe that there are approximately 10,900 market participants in the security-based swap market, of which

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1510 Proposing Release, 76 FR at 42442, supra note 3. See also Registration Adopting Release, 80 FR at 48990, supra note 965.

1511 Proposing Release, 76 FR at 42442, supra note 3. See also Registration Adopting Release, 80 FR at 48990, supra note 989.

1512 Proposing Release, 76 FR at 42442, supra note 3. See also Registration Adopting Release, 80 FR at 48990, supra note 1129.

1513 See Registration Adopting Release, 80 FR at 48990, supra note 1129.

1514 Proposing Release, 76 FR at 42442, supra note 3.

1,141 are special entities.[1515] Of the 10,900 market participants, we estimate approximately 68% of them (7,412) are also swap market participants.[1516] Based upon the number of registered municipal advisors, we estimate that there are approximately 385 third-party independent representatives for special entities.[1517] In the Proposing Release, we estimated that approximately 95% of special entities would use a third-party independent representative.[1518] Based on additional data from DTCC through 2014, the Commission currently estimates that approximately 98% of special entities would use a third-party independent representative in their security-based swap transactions.[1519] For

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1515 As discussed in the economic baseline, estimates of the number and type of market participants are based on hand classifications of TIW data for 2006-2014. Our classifications are not sufficiently granular to distinguish between ERISA special entities, and special entities defined in, but not subject to ERISA, and our estimates include both. Therefore, our estimates reflect both ERISA special entities, and entities that may choose to opt out of the special entity status under these final rules. See Sections VI.B and Section VI.C.4.i, infra.

1516 This estimation assumes that the proportion of single name CDS market participants that also use index CDS is representative of the proportion of security-based swap market participants that are swap market participants in 2014. See Section VI.B.6, infra.

1517 As of January 1, 2016 there were 665 municipal advisors registered with the Commission (http://www.sec.gov/help/foia-docs-muniadvisorshtm.html), of which 381 indicated that they expect to provide advice concerning the use of municipal derivatives or advice or recommendations concerning the selection of other municipal advisors or underwriters with respect to municipal financial products or the issuance of municipal securities. We expect that many of these municipal advisors will also act as independent representatives for other special entities. The Commission therefore estimates that approximately 385 municipal advisors will act as independent representatives to special entities with respect to security-based swaps.

1518 Proposing Release, 76 FR at 42442, supra note 3.

1519 The estimate is based on available market data for November 2006 – December 2014 provided by DTCC that indicates approximately 98% of special entities used registered or unregistered third-party investment advisers in connection with security-based swaps transactions.

purposes of calculating reporting burdens, in the Proposing Release, we estimated that 60 special entities (the remaining 5% of special entities), had employees who could serve as an in-house independent representative.[1520] The Commission currently estimates that the remaining 2% of special entities, or 25 special entities, have employees who currently negotiate on behalf of and advise the special entity regarding security-based swap transactions, and who could likely fulfill the qualifications and obligations of the independent representative.[1521] Consequently, the Commission estimates a total of 410 potential independent representatives.[1522] We received no comments on any of the foregoing estimates or our basis for the estimates.

In the Cross-Border Proposing Release, the Commission preliminarily estimated that 50 entities may include a representation that a security-based swap is a "transaction conducted through a foreign branch" in their trading relationship documentation.[1523] We estimate that, consistent with the proposal, a total of 50 entities may incur burdens under this collection of information, whether solely in connection with the business conduct requirements being adopted in this release or also in connection with the application of the de minimis exception.[1524]

Under the final rule related to substituted compliance, applications for substituted compliance may be filed by foreign financial authorities, or by non-U.S. SBS Entities.

1520 Proposing Release, 76 FR at 42442, supra note 3.

1521 The estimate is based on available market data for November 2006 – December 2014 provided by DTCC.

1522 The estimate is based on the following calculation: 385 third-party independent representatives + 25 in-house independent representatives.

1523 See Cross-Border Proposing Release, 78 FR at 31108, supra note 6.

1524 See id. See also Cross-Border Adopting Release, 79 FR at 47366, supra note 193.

Based on the analysis of recent data, the Commission staff expects that there may be approximately 22 non-U.S. entities that potentially may register as SBS Dealers, out of approximately 50 total entities that may register as SBS Dealers.[1525] Potentially, all such non-U.S. SBS Dealers, or some subset thereof, may seek to rely on substituted compliance in connection with these business conduct requirements.[1526]

In practice, the Commission expects that the greater portion of any such substituted compliance requests will be submitted by foreign financial authorities, given their expertise in connection with the relevant substantive requirements, and in connection with their supervisory and enforcement oversight with regard to security-based swap dealers and their activities.

D. Total Annual Reporting and Recordkeeping Burdens

As discussed in Section I.C., above, aspects of Rules 15Fh-1 to 15Fh-6 conform, to the extent practicable, to the business conduct standards applicable to Swap Dealers or Major Swap Participants promulgated by the CFTC.[1527] Therefore, to the extent an SBS Entity already complies with the CFTC's business conduct standards, the Commission

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1525 See U.S. Activity Adopting Release, 81 FR at 8605, supra note 17.

1526 Consistent with prior estimates, the Commission staff further believes that there may be zero to five major security-based swap participants. See Cross-Border Proposing Release, 78 FR at 31103, supra note 6. It is possible that some subset of those entities will be non-U.S. major security-based swap participants that will seek to rely on substituted compliance in connection with the business conduct requirements.

1527 See CFTC Adopting Release, supra note 21.

believes there will be minimal additional burden in complying with the requirements under the Commission's business conduct standards, as adopted.[1528]

Furthermore, a number of these rules are based on existing FINRA rules. 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 in the context of their equities businesses.

1. Verification of Status

As discussed above, the Commission estimates that approximately 55 SBS Entities (of which we expect approximately 35 will be dually registered with the CFTC as Swap Entities) will be required to verify whether a counterparty is an ECP or special entity, as required by Rule 15Fh-3(a). These verification requirements are the same under the business conduct standards adopted by the CFTC.[1529] We understand that industry has developed protocols and questionnaires that allow the counterparty to indicate its status, whether or not it is a special entity and whether it elects to be treated as

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1528 Notably, the CFTC adopted its final rules in 2012. Current estimates reflect the fact that the CFTC rules have been in place since that time, and that registrants will not incur a de novo burden in complying with the Commission's rules, which largely conform to those of the CFTC. In addition, as noted in the Proposing Release, some banks will register as SBS Dealers. 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, the banks that may register as SBS Entities are also likely already complying with similar requirements. See e.g., Risk Management of Financial Derivatives, Office of Comptroller of the Currency Banking Circular No. 277 (Oct. 27, 1993).

1529 See CFTC Adopting Release, 75 FR at 80658, supra note 21. 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.

a special entity.[1530] As a result of these protocols and questionnaires, the Commission continues to believe that these dually registered SBS Entities will not incur any start-up or ongoing burdens in complying with the rules, as adopted, because they already adhere to the relevant protocols to obtain the information under the CFTC's business conduct standards. The remaining 20 SBS Entities will each incur $500 in start-up burdens to adhere to the protocols. In addition, each counterparty that does not already adhere to the protocols will incur $500 in start-up burdens to adhere to the protocols. In addition to the $500 fee to adhere to the protocol, in order to adhere to the protocol, an adherence letter must also be submitted, the form of which is provided online. Accordingly, we conservatively estimate that one hour will be needed to input the data required to generate the adherence letter.[1531] We do not anticipate any ongoing burdens with respect to this rule. We anticipate that the parties will adhere to the protocol. We also anticipate that in connection with each transaction, SBS Entities will require counterparties to provide a certificate indicating that there are no changes to the representations included in the protocol and that reliance on those representations would be reasonable.

1530 See ISDA August 2012 DF Protocol at http://www2.isda.org/functional-areas/protocol-management/protocol/8 ("ISDA August 2012 DF Protocol").

1531 In lieu of adhering to the protocol, market participants may engage in bilateral negotiations either to obtain representations regarding the status of the counterparty or the SBS Entity may conduct due diligence to determine the status of the counterparty. However, given the relatively low cost and time burden to adhere to the protocol, we estimate that market participants will choose to adhere to the protocol rather than pay counsel to negotiate representations or conduct the necessary due diligence in the absence of any indications that reliance on such representations would not be reasonable. For the purposes of this estimate, we have assumed that reliance on the representations in the protocol would be reasonable.

As noted above, the Commission believes that approximately 7,412 of the 10,900 security-based swap market participants (which include SBS Entities and counterparties) are also swap market participants and likely already adhere to the relevant protocol.[1532] These 7,412 market participants would not have any start-up burdens or ongoing burdens with respect to verification. The remaining 3,488 market participants would incur $500 each to adhere to the protocol for an aggregate total of $1,744,000 and one hour for the adherence letter for an aggregate total of 3,488 hours.[1533]

2. Disclosures by SBS Entities

Pursuant to Rule 15Fh-3(b), (c), and (d), SBS Entities would be required to provide certain disclosures to market participants. Based on the Commission's experience with burden estimates for similar disclosure requirements,[1534] as well as our discussions with market participants,[1535] we understand that the SBS Entities that are dually registered with the CFTC already provide their counterparties with disclosures

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1532 See supra Section V.C. regarding the estimate for the number of market participants.

1533 Although we understand that ISDA offers bulk pricing for multiple entities that are part of the same corporate group or for fund families, we do not have the data as to how many of the 3,488 market participants are related entities that would be able to take advantage of this bulk pricing. As a result, we have conservatively estimated that each of the 3,488 market participants would incur the $500 fee and the hour for the adherence letter.

1534 For disclosures similar to the disclosure of methodologies and assumptions of daily mark, 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).

1535 See Proposing Release n. 14, 76 FR at 42398, supra note 3. See also, supra note 19 regarding a list of Commission staff meetings with interested parties.

similar to those required under Rules 15Fh-3(b) and (c). To the extent that the material characteristics required by Rule 15Fh-3(b)(1) are 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 believe that any additional burden will be required for the disclosure of material characteristics. For other required disclosures relating to material risks required by Rule 15Fh-3(b)(1) or disclosures relating to material incentives or conflicts of interest required by Rule 15Fh-3(b)(2), the Commission understands that certain market participants have developed standardized disclosures for some of these requirements.[1536] For example, many SBS Dealers already provide a statement of potential risks related to investing in certain security-based swaps to their counterparties. However, to the extent that an SBS Entity and counterparty engage in a highly bespoke transaction, the standardized disclosure may not satisfy all of the SBS Entities disclosure requirements. In those cases, the SBS Entity will likely use a combination of standardized disclosures and de novo disclosures to fulfill its obligations under Rules 15Fh-3(b)(1) and (2).

In some cases, such as disclosures about the daily mark for a cleared security-based swap, the SBS Entity is obligated to provide the daily mark upon request. We understand that in the current model of clearing security-based swaps, the security-based

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[1536] See e.g., ISDA General Disclosure Statement for Transactions (August 2015). To the extent that disclosures of material risks and characteristics under Rule 15Fh-3(b)(1) or disclosures of material incentives and conflicts of interest under Rule 15Fh-3(b)(2) are initially provided orally, the additional burden of providing a written version of the disclosure at or before delivery of the trade confirmation pursuant to Rule 15Fh-3(b)(3) will be considered in connection with the overall reporting and recordkeeping burdens of the SBS Entity. See Recordkeeping Release, supra note 242.

swap between the SBS Entity and counterparty is terminated upon novation by the clearing agency. The SBS Entity would no longer have any obligation to provide a daily mark to the original counterparty because a security-based swap no longer exists between them. Therefore, there would not be any ongoing burden on the SBS Entity. Depending on how quickly the security-based swap is cleared, there may not be an initial burden on the SBS Entity either. Unlike the CFTC's rule, Rule 15Fh-3(c)(1) does not require a pre-trade daily mark. So if the security-based swap is cleared before the end of the next day and the clearing results in novation of the original swap, the SBS Entity would not have any daily mark obligations for the cleared swap.

For uncleared security-based swaps, the Commission believes that SBS Entities may need to slightly modify the models used for calculating variation margin to calculate the daily mark. In addition, the SBS Entity will need to provide the counterparty with a description of the methodologies and assumptions used to calculate the daily mark.

Nevertheless, 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, require disclosures similar to the description of the methodologies and assumptions of the daily mark. To the extent that the model it uses and methodologies and assumptions are not already prepared, the SBS Entity may need to prepare the initial description of the data sources, methodologies and assumptions. In addition, the SBS Entity will have an ongoing burden of updating the disclosure for any material changes to the data sources, methodologies and assumptions.

The Commission continues to believe that SBS Entities will use internal staff to revise existing disclosures to comply with Rules 15Fh-3(b) and (c), and to assist in preparing language to comply with Rule 15Fh-3(d) regarding the clearing options available for a particular security-based swap. In addition, the requirements of Rule 15Fh-3(d) are not the same as the CFTC requirements to disclose clearing choices, so SBS Entities will need to develop new disclosures.

The Commission estimates that in 2014 there has been approximately 740,700 security-based swap transactions between an SBS Dealer and a counterparty that is not an SBS Dealer. Of these, the Commission estimates that approximately 428,000 were new or amended trades requiring these disclosures.[1537] In view of the factors discussed in the Economic Analysis section and elsewhere in this release, the Commission recognizes that the time required to develop an infrastructure to provide these disclosures will 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, whether the security-based swap is cleared or uncleared and other applicable regulatory requirements. Under the rule, as adopted, SBS Entities could make the required disclosures to their counterparties through standardized documentation, such as a master agreement or other written agreement, if the parties so agree. The Commission recognizes that it will likely be necessary to prepare some disclosures that

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[1537] Available DTCC-TIW data for 2014 indicated approximately 740,700 transactions between SBS Entities and non-SBS Entities during that time period. Of these, approximately 240,000 were new trades, and 188,000 were amendments. Of the approximately 240,000 new trades between likely SBS Dealers and non-dealers, only 1,000 trades or approximately 0.5% were voluntarily cleared bilateral trades in 2014.

are particular to a transaction to meet all of an SBS Entity's disclosure obligations under Rules 15Fh-3(b), (c) and (d). The Commission also believes that, because the reporting burden will generally require refining or revising an SBS Entity's existing disclosure processes, the disclosures will be prepared internally.

Given the foregoing, the Commission continues to conservatively estimate that on average, SBS Entities will 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, to comply with the rules.[1538] This team will analyze the changes necessary to comply with the new disclosure requirements, including the redesign of current compliance systems, if necessary, as well as the creation of functional requirements and system specifications for any systems development work that may be needed to automate the disclosure process.[1539] This will amount to an aggregate initial burden of 66,000 hours.[1540]

Following the initial analysis and development of specifications, the Commission continues to estimate that half of these persons will still be required to spend 20 hours annually to re-evaluate and modify the disclosures and system requirements as necessary,

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1538 In the Proposing Release, the Commission used this estimate and it recognizes the development of market practice to comply with very similar CFTC rules. It also recognizes that given the current model used for clearing security-based swaps, daily mark disclosures in that context are unlikely to be required. Furthermore, no comments were received on these estimates. As a result, the Commission conservatively continues to use these estimates.

1539 Some SBS Entities may choose to utilize in-house counsel to review, revise and prepare these disclosures.

1540 The estimate is based on the following calculation: (55 SBS Entities) x (12 persons) x (100 hours).

amounting to an ongoing annual burden of 6,600 hours.[1541] In addition, the Commission estimates that on average, the SBS Entities will require one burden hour per security-based swap to evaluate whether more particularized disclosures are necessary for the transaction and to develop the additional disclosures for an aggregate ongoing burden of 428,000 hours.[1542]

The Commission also continues to estimate that, to create and maintain an information technology infrastructure to the specifications identified by the team of persons from trading and structuring, legal, operations and compliance described above, each SBS Entity will require, on average, eight full-time persons for six months of systems development, programming and testing, amounting to a total initial burden of 440,000 hours.[1543] The Commission continues to estimate that maintenance of this system will require two full-time persons for a total ongoing burden of 220,000 hours annually.[1544]

3. Know Your Counterparty and Recommendations

1541 The estimate is based on the following calculation: (55 SBS Entities) x (6 persons) x (20 hours).

1542 The estimate is based on the following calculation: (428,000 security-based swaps that require these disclosures) X (1 hour). The Commission realizes that some assessments may take less time and some may take more. In addition, to the extent that additional disclosures are required, drafting the disclosure is likely to take more than an hour, but we expect the vast majority of transactions will not require additional disclosures so that an average of one hour per transaction is a reasonable estimate.

1543 The estimate is based on the following calculation: (55 SBS Entities) x (4 persons) x (2000 hours).

1544 The estimate is based on the following calculation: (55 SBS Entities) x (2 persons) x (2000 hours).

As noted in the Proposing Release, 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.[1545] The Commission continues to believe that most SBS Dealers already have policies and procedures in place for knowing their counterparties, to comply with existing CFTC and FINRA standards. The Commission estimates that, on average, the rules will require each SBS Dealer to initially spend approximately five hours to review existing policies and procedures and to document the collection of information necessary to comply with its "know your counterparty" obligations – for a total initial burden of 250 hours. The Commission also continues to estimate that an SBS Dealer will 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 rules' know your counterparty requirements – a total ongoing burden of approximately 11,500 hours annually,[1546] or an average of 230 hours annually per SBS Dealer.[1547]

1545 See Proposing Release n. 14, 76 FR at 42398, supra note 3. See also supra note 19 regarding a list of Commission staff meetings with interested parties.

1546 The estimate is based on the following calculation: (23,000 unique SBS Dealer – non-dealer counterparty pairs) x 30 minutes / 60 minutes. In the Proposing Release, the Commission estimated 47,000 unique SBS Dealer—non-dealer counterparty pairs. Based on updated DTCC-TIW data, we now estimate 23,000 SBS Dealer – non-dealer counterparty pairs.

1547 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.

In addition, the Commission estimates that the counterparties will require approximately ten hours for each counterparty or its agent to collect and provide essential facts to the SBS Dealer for a total initial burden of 109,000 hours.[1548]

The Commission expects that, given the institutional nature of the participants involved in security-based swaps, most SBS Dealers will obtain the representations in Rules 15Fh-3(f)(2) and (3) to comply with Rule 15Fh-3(f).[1549] For the 1,141 special entities, we expect SBS Entities will not act as an advisor pursuant to Rule 15Fh-2(a) and accordingly, the burden estimates for the SBS Entities and special entities are included in the context of the discussion for that rule, infra. For the 7,412 security-based swap market participants that are also swap market participants, including the thirty-five firms that we expect to be dually registered as Swap Dealers and SBS Dealers, most of the requisite representations have been drafted for the swaps context.[1550] We understand that swap market participants are currently utilizing standardized representations that are currently in Schedule 3 of the ISDA August 2012 DF Protocol. The $50 million institutional suitability threshold is consistent with the institutional suitability exception in FINRA standards, but may require SBS Dealers to obtain an additional representation or conduct due diligence to determine the counterparty has total assets of at least $50

1548 The estimate is based on 10,900 market participants X 10 hours.

1549 The Commission bases its expectation on its observation and experience in the context of transactions by broker-dealers with institutional clients and the use of FINRA's institutional suitability exception in that context.

1550 Of the 7,412 market participants that engage in both swaps and security-based swaps, a proportion of them will also be special entities. This calculation assumes all of the special entities are engaged in transactions in both markets, leaving 6,271 market participants (7,412 market participants – 1,141 special entities) to adapt the representations in the ISDA August 2012 DF Protocol to the security-based swap context, as necessary.

million. To the extent that any modifications are necessary to adapt those representations to the security-based swap context, we conservatively estimate that market participants will each require two hours to assess the necessity and make any necessary modifications for the security-based swap context for an aggregate initial burden of 12,542 hours for the market participants that participate in both the security-based swaps market and the swaps market.[1551] We do not anticipate any ongoing burden with respect to the requisite representations because the representations in the swaps context are deemed repeated "as of the occurrence of each Swap Communication Event" and we would anticipate a similar construction in the security-based swap context. For the remaining 3,488 market participants, we expect that they will draft the requisite representations to comply with the institutional suitability analysis in Rule 15Fh-3(f)(2). We also anticipate that these 3,488 market participants are likely to model their representations on the representations included in the ISDA August 2012 DF Protocol because the SBS Entity is already familiar with those particular representations. Accordingly, we estimate that the remaining 3,488 market participants will each require five hours to review and agree to representations similar to those included in such protocol for an aggregate initial burden of 17,440 hours.[1552] Again, we do not anticipate an ongoing burden for these representations for the reasons set forth above.

4. Fair and Balanced Communications

1551 This calculation is based on the assumption that all of the special entities are engaged in both the swaps market and the security-based swaps market and that the special entities will choose to comply with the safe harbor of Rule 15Fh-5(b). (7,412 market participants – 1,141 special entities) X (2 hours).

1552 This estimate is based on the following calculation: (3,488 market participants) X (5 hours).

Rule 15Fh-3(g) requires SBS Entities to communicate with counterparties "in a fair and balanced manner, based on principles of fair dealing and good faith." The three specific standards of Rule 15Fh-3(g) require that: (1) 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; (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 or trading strategy involving a security-based swap shall be balanced by an equally detailed statement of the corresponding risks.[1553] We expect that a discussion of material risks of the transaction will be included in the documentation for the security-based swap. The Commission believes that all 55 SBS Entities will be required to comply with Rule 15Fh-3(g), and that they will likely send their existing marketing materials to outside counsel for review and comment. Accordingly, the Commission continues to believe that each SBS Entity will likely incur $6,000 in legal costs, or $330,000 in the aggregate initial burden, to draft or review statements of potential opportunities and corresponding risks in the marketing materials

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[1553] To the extent that the 16 registered broker-dealers that are expected to register as SBS Entities are also FINRA members, they are already subject to these similar FINRA requirements in the non-security based swap context. Cf. FINRA Rule 2210(d)(1)(D) ("Members must ensure that statements are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits. Communications must be consistent with the risks of fluctuating prices and the uncertainty of dividends, rates of return and yield inherent to investments.") The Commission believes that this requirement addresses concerns raised by a commenter that to be fair and balanced, communications must inform investors of both the potential rewards and risks of their investments. See Levin, supra note 5.

for single name and narrow based index credit default swaps, total return swaps and other security-based swaps.[1554]

The Commission additionally believes that compliance with Rule 15Fh-3(g) would require a review of SBS Entities' other communications to their counterparties, such as e-mails and Bloomberg messages. However, we believe that such additional communications would likely be reviewed internally, by in-house legal counsel or an SBS Entity's CCO. We estimate that the initial internal burden hours associated with this review would be approximately six hours, for an aggregate total of 330 hours.[1555]

For more bespoke transactions, the cost for outside counsel to review the marketing materials will depend on the complexity, novelty and nature of the product, but the Commission expects a higher cost associated with the review for more novel products. The Commission accordingly estimates an initial, aggregate compliance cost for the marketing materials relating to bespoke single name and narrow based index credit default swaps, total return swaps and other security-based swaps at $462,000.[1556] As stated above in Section II.G.5, Rule 15Fh-3(g) applies to communications made before the parties enter into a security-based swap, and continues to apply over the term

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1554 The Commission estimates that the review of marketing materials for these three categories of security-based swaps would require 5 hours of outside counsel time, at an average cost of $400 per hour. This estimate also assumes that each SBS Entity engages in all three categories of security-based swaps.

1555 The Commission estimates that the review of additional communications for these three categories of security-based swaps would require internal burden hours for each of the 55 SBS Entities. This estimate also assumes that each SBS Entity engages in all three categories of security-based swaps.

1556 The Commission estimates the review of the marketing materials for each of these categories would require seven 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.

of a security-based swap. The Commission believes that the ongoing compliance costs associated with the rule will likely be limited to a review of SBS Entities' e-mail communications sent to counterparties, which we believe will likely be done by in-house counsel. We estimate that the ongoing compliance costs of the rule will be approximately two burden hours, for an aggregate total of 330 hours.[1557]

5. Supervision

As outlined above, Rule 15Fh-3(h) requires an SBS Entity to establish and maintain a system to supervise, and to diligently supervise, its business and the activities of its associated persons. Such a system shall be reasonably designed to prevent violations of the provisions of applicable federal securities laws and the rules and regulations thereunder relating to its business as an SBS Entity. The written policies and procedures required by Rule 15Fh-3(h) must include, at a minimum, procedures for nine specific areas of supervision.

As for the number of SBS Entities respondents, the Commission continues to estimate that approximately 55 SBS Entities (of which we expect approximately 35 will be dually registered with the CFTC as Swap Entities) will be required to comply with analogous supervision rules like those required by Rule 15Fh-3(h).[1558] The supervision

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1557 The Commission estimates that the review of additional communications for these three categories of security-based swaps would require two internal burden hours for each of the 55 SBS Entities. This estimate also assumes that each SBS Entity engages in all three categories of security-based swaps.

1558 Proposing Release, 76 FR at 42442, supra note 3. See also Registration Adopting Release, 80 FR at 48990, supra note 1129.

requirements in Rule 15Fh-3(h) are largely the same under the business conduct standards and related rules adopted by the CFTC.[1559]

The estimates in this paragraph reflect the foregoing information, as well as the Commission's general experience with and understanding of the burden estimates in similar contexts, including, but not limited to, FINRA's analogous supervision rules. While each of the nine written policies and procedures required, at a minimum, by Rule 15Fh-3(h) will vary in cost, the Commission continues to estimate that such policies and procedures will require, on average, 210 hours per respondent, per policy and procedure to initially prepare written policies and procedures in order to establish a system to diligently supervise those policies and procedures, or an average of 1,890 burden hours per SBS Entity – resulting in an initial aggregate burden of 103,950 hours.[1560] The Commission also continues to expect that many SBS Entities will primarily rely on outside counsel for the collection of information required under this rule at a rate of $400 per hour, for an average of 450 hours per respondent, with a minimum of nine policies and procedures, resulting in an outside initial cost burden of $180,000 per respondent – or

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1559 See Commodity Exchange Act Rule 23.602. See also Commodity Exchange Act Rule 23.402(a) (policies and procedures to ensure compliance); Commodity Exchange Act Rule 3.3(d)(1) (administration of compliance policies and procedures). Accordingly, the SBS Entities that would also be registered as a swap dealer or major swap participant with the CFTC would have supervision policies and procedures for engaging in swaps.

1560 See Proposing Release, 76 FR at 42446, supra note 3. The estimate is based on the following calculation: (210 hours) x (9 policies and procedures) x (55 SBS Entities). The estimates reflected do not include the burden and cost of actually complying with the underlying substance of these written policies and procedures as that is beyond the scope of the PRA analysis.

an aggregate initial cost of $9,900,000.[1561] Once these policies and procedures are established, the Commission continues to estimate that, on average, each SBS Entity will spend approximately 540 hours (approximately 60 hours per policy and procedure) each year to maintain these policies and procedures, yielding a total ongoing annual burden of approximately 29,700 internal burden hours (55 SBS Entities x 540 hours).[1562] The Commission believes that the maintenance of these policies and procedures will be conducted internally.

6. SBS Dealers Acting as Advisors to Special Entities

As discussed above, Rule 15Fh-4 imposes on SBS Dealers that act as advisors to special entities a duty to make a reasonable determination that any security-based swap or related trading strategy that the SBS Dealer recommends is in the "best interests" of the special entity. Rule 15Fh-2(a) states that an SBS Dealer "acts as an advisor" to a special entity when it recommends a security-based swap or related trading strategy to the special entity. However, the rule provides a safe harbor whereby an SBS Entity will not be deemed an "advisor" if an ERISA special entity counterparty relies on advice from an ERISA fiduciary, or where any special entity counterparty relies on advice from a qualified independent representative that acts in its best interests.[1563]

In the Proposing Release, the Commission recognized the inherent tensions that arise where SBS Dealers recommend a security-based swap or related transaction to

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1561 Some SBS Entities may choose to utilize in-house counsel to initially prepare these policy and procedure, which would mitigate the aggregate initial cost, but the Commission's estimate of $9,900,000 reflects a conservative assumption of SBS Entities primarily relying on outside counsel to prepare these materials.

1562 See Proposing Release, 76 FR at 42446, supra note 3.

1563 Rule 15Fh-2(a)(1)-(2).

special entity counterparties.[1564] Given the parties' incentive to transact in security-based swaps, the Commission believes that the parties are likely to resolve these tensions by providing the necessary representations and disclosures to meet the requirements of the safe harbor under Rule 15Fh-2(a)(1)-(2), such that an SBS Dealer will not be deemed to act as an advisor to a special entity, particularly for transactions in which the SBS Dealer is the counterparty to the transaction.

Among swap dealers operating under the CFTC's parallel safe harbor,[1565] parties have generally included representations in standard swap documentation that both counterparties are acting as principals, and that the counterparty is not relying on any communication from the swap dealer as investment advice. We believe that SBS Dealers and their special entity counterparties will similarly include the requisite representations in standard security-based swap documentation. These representations will need to be reviewed and revised to ensure that they comply with the rules the Commission adopts today.

As stated in the Proposing Release, the Commission continues to believe that the 50 SBS Dealers will primarily rely on in-house counsel for compliance with this rule, each of which will need approximately five internal burden hours to draft, review and revise the representations in its standard security-based swap documentation to comply with Rule 15Fh-2(a)(1)-(2), for an initial aggregate burden of 250 hours.[1566] The

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1564 See Proposing Release, 76 FR at 42424, supra note 3.

1565 See CFTC Regulation § 23.440(b)(1)-(2).

1566 See Proposing Release, 76 FR at 42446, supra note 3. This estimate is based on multiplying the number of SBS Dealers (50) by the number of estimated internal burden hours (5).

Commission also believes that, once an SBS Dealer revises the language of the representations to meet the requirements of Rule 15Fh-2(a)(1)-(2), such language will become part of the SBS Dealer's standard security-based swap documentation and, accordingly, there will be no further ongoing burden associated with this rule. For transactions in which an SBS Dealer is not a counterparty and chooses to act as an advisor, the Commission estimates that an SBS Entity will require approximately 20 internal burden hours to collect the requisite information from each special entity, for an aggregate initial burden of approximately 1,700 hours.[1567]

7. SBS Entities Acting as Counterparties to Special Entities

Where a special entity is a counterparty to a security-based swap, Rule 15Fh-5(a)(1) requires an SBS Entity to have a reasonable basis for believing that the special entity has a qualified independent representative that meets specified requirements. Where the special entity counterparty is an ERISA plan, under Rule 15Fh-5(a)(2), the SBS Entity must have a reasonable basis to believe that the ERISA plan is represented by an ERISA fiduciary. The Commission believes that written representations will likely provide the basis for establishing an SBS Entity's reasonable belief regarding the qualifications of the independent representative.

As stated in the Proposing Release, the Commission continues to believe that the burden for determining whether an independent representative is independent of the SBS

[1567] This estimate is based on available market data for November 2006 – September 2014 provided by DTCC that indicates 85 unique pairs of SBS Dealers and U.S. special entities without a third-party investment adviser. Based on 2014 single name CDS data in DTCC-TIW, there were 2 unique trading relationships between likely SBS Dealers and special entities without a third party investment adviser, which entered into 272 new trades and 200 terminations, representing 0.039% of all transactions in 2014.

Entity will depend on the size of the independent representative, the size of the SBS Entity, and the volume of transactions with which each is engaged. The Commission further believes that each SBS Entity would initially require written representations regarding the qualifications of a special entity's independent representative, but would only require updates to the independent representative's qualifications in subsequent dealings with the same independent representative throughout the duration of the swap term, provided the volume and nature of the security-based swap transaction remain the same.

Regarding the initial burden estimates for SBS Entities, the Commission's updated estimates reflect that each SBS Entity will interact with and be required to form a reasonable basis regarding the qualifications of approximately 385 independent, third-party representatives and 25 in-house independent representatives, for a total of 410 independent representatives. In the Proposing Release, the Commission estimated an average internal burden of 15 hours for each SBS Entity per independent representative. We have increased this estimate based on changes to the representations that SBS Entities will have to obtain and now estimate that each SBS Entity, on average, will initially require approximately 15.5 internal burden hours from the SBS Entity's own in-house counsel per independent representative to collect the information necessary to comply with this requirement. This will result in an aggregate initial burden of 349,525internal hours (15.5 hours x 410 independent representatives x 55 SBS Entities).[1568] We do not believe there will be any external burdens associated with this rule.

[1568] While the Commission does not believe that every SBS Entity is likely to deal with every independent representative, we do not have data on the average

With regard to SBS Entities' ongoing burden, the Commission believes that such burden would be minimal, since, once an SBS Entity forms a reasonable basis to believe that a given independent representative meets the qualifications of Rule 15Fh-5, the SBS Entity will not likely need to reaffirm that independent representative's qualifications anew, but could instead rely on past representations regarding the representative's qualifications. We estimate that SBS Entities will incur an ongoing, aggregate burden of 22,500 hours (1 hour x 55 SBS Entities x 410 independent representatives) per year as a result of this rule.

In addition to the burdens imposed on SBS Entities, Rule 15Fh-5(a)(1) will also impose a burden on special entities' independent representatives to collect the necessary information regarding their relevant qualifications, and provide that information to the SBS Entity and/or the special entity. The Commission continues to believe that the reporting burden for the independent representative will consist of providing written representations to the SBS Entity and/or the special entity it represents. The Commission believes that the burden associated with an independent representative's obligation to assess its independence from the SBS Entity will likely depend on the size of the independent representative, the size of the SBS Entity, the interactions between the independent representative and the SBS Entity, the policies and procedures of the independent representative and depend less on the number of transactions in which the independent representative is engaged. The policies and procedures of the independent representative will facilitate its ability to quickly assess, disclose, manage and mitigate

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number of independent representatives with whom each SBS Entity would deal. Accordingly, for the purposes of these calculations, we have assumed that each SBS Entity will deal with each independent representative.

any potential material conflicts of interest. We now believe the number of transactions in which the independent representative engages is less likely to impact this assessment. Accordingly, we have updated our estimates.

We anticipate that independent representatives will rely on in-house counsel to collect and submit the relevant documentation and information regarding its qualifications. The Commission also estimates that each independent representative, on average, will initially require approximately 16 internal burden hours from its in-house counsel per SBS Entity to collect the information necessary to comply with this requirement.[1569] This will result in an aggregate initial burden of 360,800 internal hours (16 hours x 410 independent representatives x 55 SBS Entities).

As with SBS Entities' ongoing burden associated with this rule, the Commission believes that the ongoing burden imposed on independent representatives would be minimal, since, once the independent representative has provided information regarding its qualifications to the SBS Entity, the independent representative will not likely need to collect or provide that information again, but could instead rely on a bring down certificate that reflects past representations regarding its qualifications. We estimate that independent representatives will incur an ongoing, aggregate burden of 22,500 hours (1

[1569] While the Commission does not believe that every independent representative is likely to deal with every SBS Entity, we do not have data on the average number of SBS Entities with whom each independent representative would deal. Accordingly, for the purposes of these calculations, we have assumed that each SBS Entity will deal with each independent representative.

hour x 55 SBS Entities x 410 independent representatives) per year as a result of this rule.[1570] We do not believe there will be external burdens associated with this rule.

8. Political Contributions

As noted above, the Commission believes that there will be approximately 50 SBS Dealers subject to these rules, and estimates that all of them will provide, or will seek to provide, security-based swap services to municipal entities. SBS Dealers, in order to supervise and assess internal compliance with the pay to play rules, will need to collect information regarding the political contributions of SBS Dealers and their covered associates. In addition, SBS Dealers' covered associates will also need to collect and provide the information required by these rules to SBS Dealers.

The Commission's estimates in this paragraph take into account the burden of the covered associates and the SBS Dealers. These estimates also reflect the Commission's experience with and burden estimates for similar requirements, as well as our discussions with market participants.[1571] Based on the foregoing, the Commission estimates that it will take, on average, approximately 185 hours per SBS Dealer – resulting in a total

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1570 We note that, in the Proposing Release, we based our burden estimates for evaluating an independent representative's qualifications on the underlying assumption that representations regarding an independent representative's qualifications must be provided prior to every transaction, and therefore the associated burden calculations were transaction-specific. See Proposing Release, 76 FR 42446-7, supra note 3. However, based on the observed practices of swap market participants, we now believe that representations regarding an independent representative's qualifications need only be provided in the context of each relationship with an SBS Entity. Our revised calculations, which are now relationship-specific, reflect this shift in our underlying assumption.

1571 See Advisers Act Pay-to-Play Release, 75 FR 41018, 41061- 65, supra note 1100. See also supra note 19 regarding a list of Commission staff meetings with interested parties.

initial burden of 9,250 hours[1572] to collect the information regarding the political contributions of SBS Dealers and their covered associates to assist SBS Dealer in their compliance with the rule. The Commission believes that many SBS Dealers will primarily rely on in-house counsel for the collection of information required under this rule.

Additionally, we expect some SBS Dealers to incur one-time costs to establish or enhance current systems to assist in their compliance with the rule. These costs will vary widely among firms. Similar to the estimates made by the Commission in connection with the Advisers Act pay to play rule, we have also estimated that some small and medium firms will incur start-up costs, on average, of $10,000, and larger firms will incur, on average, $100,000. Assuming all SBS Dealers will be larger firms, the initial cost to establish or enhance current systems to assist in their compliance with the rule is estimated at $5,000,000 for all SBS Dealers.[1573] Nevertheless, we note that some SBS Dealers may not incur any system costs if they determine a system is unnecessary due to their limited number of employees, or their limited number of municipal entity counterparties. Furthermore, like other large firms, SBS Dealers have likely devoted significant resources to automating compliance and reporting with respect to regulations concerning certain political contributions. This rule could, therefore, cause them to enhance the existing systems that had originally been designed to comply with MSRB Rules G-37 and G-38 and Advisers Act Rule 206(4)-5.

1572 The estimate is based on the following calculation: (185 hours x 50 SBS Dealers).

1573 The initial cost is estimated at: 50 SBS Dealers x $100,000 = $5,000,000. See Advisers Act Pay-to-Play Release, 75 FR at 41061, supra note 1100 (estimating that larger firms will incur, on average, $100,000, in start-up costs).

The final rules also allow SBS Dealers to file applications for exemptive relief, and outline a list of items to be addressed, including, whether the SBS Dealer has developed policies and procedures to monitor political contributions; the steps taken after discovery of the contribution; and the apparent intent in making the contribution based on the facts and circumstances of each case. The incidence of exemptive relief related to MSRB Rule G-37 and the number of applications the Commission has received under the Advisers Act Rule 206(4)-5 may be indicative of the possible applications for exemptive relief under these final rules. Consistent with the Commission's estimates in connection with Advisers Act Rule 206(4)-5, we also estimate that a firm that applies for an exemption will hire outside counsel to prepare an exemptive request, and estimate that the number of hours counsel will spend preparing and submitting an application between 16 hours to 32 hours, at a rate of $400 per hour. Recognizing that this is an estimate, we conservatively estimate that the Commission may receive up to two applications for exemptive relief per year with respect to pay to play rules.[1574] at a total ongoing cost of $25,600 per year, assuming conservatively 32 hours for outside counsel to prepare an exemptive request.[1575]

9. Chief Compliance Officer

Under Rule 15Fk-1, an SBS Entity's CCO is responsible for, among other things, taking reasonable steps to ensure that the SBS Entity establishes and maintains policies

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1574 FINRA has granted 17 exemptive letters related to Rule G-37 between 1/05 and 12/15 (11 years) http://www.finra.org/industry/exemptive-letters. In addition, the Commission has received 13 applications under the Adviser's act (since the compliance date, approximately 4 years).

1575 Ongoing: (Outside counsel at $400 per hour x 32 hours per application x 2) = $25,600. See Advisers Act Pay-to-Play Release, 75 FR at 41065, supra note 1100 (making similar estimates in connection with Advisers Act Rule 206(4)-5).

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. The Commission continues to estimate that, on average, the establishment and administration of the policies and procedures required under Rule 15Fk-1 (e.g., preparing an annual compliance report and the SBS Entity's annual assessment of its written policies and procedures reasonably designed to achieve compliance with Section 15F and the rules and regulations thereunder) will require 630 hours to create and 180 hours to administer per year per respondent, for a total burden of 34,650 initial hours, and 9,900 hours per year on average, on an ongoing basis.[1576] The Commission also continues to estimate that a total of $60,000 in outside legal costs will be incurred to, among other things, assist in the preparation of the annual compliance report and the SBS Entity's annual assessment of its written policies and procedures, as a result of this burden per respondent, for a total initial outside cost burden of $3,300,000.[1577]

A CCO will also be required to prepare and submit annual compliance reports to the Commission and the SBS Entity's board of directors. In the Proposing Release, the Commission estimated that these reports would require on average 92 hours per respondent per year for an ongoing annual burden of 5,060 hours. As a result of additional descriptions that some CCOs will have to include in their annual compliance reports, we now estimate that these reports will require on average 93 hours per

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1576 See Proposing Release, 76 FR at 42448, supra note 3.

1577 See id. 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, supra note 1202.

respondent per year for an ongoing annual burden of 5,115.[1578] Because the report will be submitted by an internal CCO, the Commission does not expect any external costs associated therewith.

10. Foreign Branch Exception

The Commission estimates the one-time paperwork burden associated with developing representations under this collection of information would be, for each U.S. bank counterparty that may make such representations to its registered Major SBS Participant or registered SBS Dealer counterparty, no more than five hours, and up to $2,000 for the services of outside professionals, for an estimate of approximately 250 hours and $100,000 across all security-based swap counterparties that may make such representations.[1579] This estimate assumes little or no reliance on standardized disclosure language.

However, as the Commission has previously noted in connection with this collection of information, in most cases, the representations associated with the definition of "transaction conducted through a foreign branch" are likely to be made through amendments to the parties' existing trading documentation (e.g., the schedule to a master agreement).[1580] Because these representations relate to new regulatory requirements, the

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1578 The estimate is based on the following calculation: (93 hours) x (55 SBS Dealers).

1579 See Cross-Border Proposing Release, 78 FR at 31108, supra note 6 (explaining that the Commission estimated that 50 entities may include a representation that security-based swap is a "transaction conducted through a foreign branch" in their trading relationship documentation).

1580 See Cross-Border Adopting Release, 79 FR at 47366, supra note 193. See also Cross-Border Proposing Release, 78 FR at 31108, supra note 6 (noting that entities may include the representation in their trading relationship documentation). The Commission believes that because trading relationship documentation is established between two counterparties, the question of whether

Commission anticipates that U.S. bank counterparties may elect to develop and incorporate these representations in trading documentation soon after the effective date of the Commission's security-based swap regulations, rather than incorporating specific language on a transactional basis. The Commission believes that parties would be able to adopt, where appropriate, standardized language across all of their security-based swap trading relationships.

The Commission expects that the majority of the burden associated with the new disclosure requirements will be experienced during the first year as language is developed and trading documentation is amended. After the new representations are developed and incorporated into trading documentation, the Commission continues to believe that the on-going paperwork burden associated with this requirement will be 10 hours per U.S. bank counterparty for verifying representations with existing counterparties, for a total of approximately 500 hours across all applicable U.S. bank counterparties.[1581]

11. Substituted Compliance Rule

Rule 3a71–6 under the Exchange Act would require submission of certain information to the Commission to the extent that foreign financial authorities or security-based swap dealers or major security-based swap participants elect to request a

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one of those counterparties is able to represent that it is entering into a "transaction conducted through a foreign branch" would not change on a transaction-by-transaction basis and, therefore, such representations would generally be made in the schedule to a master agreement, rather than in individual confirmations.

[1581] The Commission staff estimates that this burden would consist of 10 hours of in-house counsel time for each security-based swap market participant that may make such representations. See Cross-Border Adopting Release, 79 FR 47367 (estimating 10 hours per counterparty for verification), supra note 193; Cross-Border Proposing Release, 78 FR 31108 (same), supra note 6.

substituted compliance determination with respect to the Title VII business conduct requirements. Consistent with Exchange Act Rule 0-13, such applications must be accompanied by supporting documentation necessary for the Commission to evaluate the request, including information regarding applicable foreign requirements, and the methods used by foreign authorities to monitor and enforce compliance.

The Commission expects that registered security-based swap dealers and major security-based swap participants will seek to rely on substituted compliance upon registration, and that it is likely that the majority of such requests will be made during the first year following the effective date of this substituted compliance rule. Requests would not be necessary with regard to applicable rules and regulations of a foreign jurisdiction that have previously been the subject of a substituted compliance determination in connection with the applicable rules.

In light of the provisions of the final rule and rule 0-13, permitting substituted compliance applications to be made by foreign regulatory authorities, the Commission expects that the great majority of substituted compliance applications will be submitted by foreign authorities, and that very few substituted compliance requests will come from SBS Entities. For purposes of this assessment, the Commission estimates that three such SBS Entities will submit such applications.[1582] The Commission estimates that the total one-time paperwork burden incurred by such entities associated with preparing and

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[1582] This estimate differs from the Cross-Border Proposing Release estimate, that there would be no more than 50 requests for substituted compliance determinations pursuant to proposed Rule 3a71-5. See Cross-Border Proposing Release, 78 FR at 31110, supra note 6. The revised estimate reflects our expectation that the large majority of substituted compliance requests will be made by foreign regulatory authorities, rather than by market participants.

submitting a request for a substituted compliance determination in connection with the business conduct requirements will be approximately 240 hours, plus $240,000 for the services of outside professionals for all three requests.[1583]

E. Collections of Information are Mandatory

With the exception of the collection of information related to the foreign branch exception, compliance with collection of information requirements under these rules is mandatory for all SBS Dealers and SBS Entities. 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.

Compliance with the collection of information requirements associated with rule 3a71-6, regarding the availability of substituted compliance, is mandatory for all foreign financial authorities or non-U.S. SBS Entities that seek a substituted compliance determination.

F. Confidentiality

The forms that the Commission has adopted for use by applicants for registration as security-based swap dealers or major security-based swap participants provide for applicants to notify the Commission regarding intended reliance on substituted

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1583 Consistent with the per-request estimates in the Cross-Border Proposing Release, the Commission estimates that the paperwork burden associated with making each such substituted compliance request would be approximately 80 hours of in-house counsel time, plus $80,000 for the services of outside professionals (based on 200 hours of outside time * 400). See Cross-Border Proposing Release, 78 FR at 31110, supra note 6.

In practice, those amounts may overestimate the costs of requests pursuant to Rule 3a71-6 as adopted, as such requests would solely address business conduct requirements, rather than the broader proposed scope of substituted compliance set forth in that proposal.

compliance.[1584] Also, the Commission generally will make requests for substituted compliance determination public, subject to requests for confidential treatment being submitted pursuant to any applicable provisions governing confidentiality under the Exchange Act.[1585]

The representations provided in connection with the foreign branch exception would be provided voluntarily by certain U.S. bank counterparties to their registered SBS Dealer counterparties; therefore, the Commission would not typically receive confidential information as a result of this collection of information. However, to the extent that the Commission receives confidential information contained in a representation document through our examination and oversight program, an investigation, or some other means, such information would be kept confidential, subject to the provisions of applicable law.

G. Retention Period of Recordkeeping Requirements

SBS Dealers will be required to retain records and information relating to these rules for the required retention periods specified in Exchange Act Rule 17a-4.

VI. Economic Analysis

A. Introduction and Broad Economic Considerations

The Commission is sensitive to the costs and benefits imposed by its rules. This section presents an analysis of the particular economic effects – including costs, benefits

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1584 See Registration Adopting Release, 80 FR at 49049, supra note 989 (questions 3A, B and C of Form SBSE-A, addressing potential reliance on substituted compliance determinations)

1585 See SBS Entity Definitions Adopting Release, 79 FR at 47359, supra note 1451 (discussing confidentiality provisions under the Exchange Act in connection with adopting Rule 0-13, governing applications for substituted compliance).

and impact on efficiency, competition, and capital formation – that may result from our final rules. Section 3(f) of the Exchange Act requires the Commission, when engaging in rulemaking that requires the Commission 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 will promote efficiency, competition, and capital formation. Further, Section 23(a)(2) of the Exchange Act requires the Commission, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition and to not adopt any rule that would impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. In the Proposing Release, the Commission solicited comments on all aspects of the costs and benefits associated with the proposed rules, including any effect the proposed business conduct rules may have on efficiency, competition, and capital formation.[1586] The Commission has considered these comments and has modified some of the rules being adopted as discussed in sections I, II and III, supra.

The business conduct rules as adopted implement the requirements under Sections 15F(h) and 15F(k) of the Exchange Act as added by Section 764(a) of the Dodd-Frank Act. As discussed in Section VI.C, infra, the final rules include both requirements expressly addressed by Title VII of the Dodd-Frank Act, as well as discretionary rules designed to further the principles which underlie the statutory requirements. These discretionary rules include requirements to make certain additional disclosures; certain "know your counterparty" obligations; suitability obligations for SBS Dealers;

[1586] See Proposing Release, supra note 3.

prohibitions against certain "pay to play" activities; and a requirement of board approval for decisions related to the compensation or removal of the CCO.

SBS Entities play a central role in intermediating transactions in complex and opaque security-based swaps, and enjoy significant informational advantages compared to their less sophisticated counterparties. For instance, SBS Dealers observe quote solicitations and order flow. SBS Dealers may also act as lenders, placement agents, underwriters, structurers or securitizers of the securities underlying security-based swaps. As a result of operating in such additional capacities, SBS Dealers may have superior information about the quality of security-based swaps and of securities underlying security-based swaps. Major SBS Participants may have lower volumes of dealing activity than SBS Dealers, but may hold large concentrated positions in security-based swaps,[1587] and may have specialized expertise in pricing and trading security-based swaps. At the same time, less informed and less sophisticated counterparties do not observe order flow, may have less information concerning the risks and expected returns of security-based swaps and reference securities, and may have less expertise in valuing complex security-based swaps.

In addition, SBS Dealers are for-profit entities with business incentives that may be competing with those of their counterparties. Due to the nature of their market making and intermediation roles, SBS Dealers purchase security-based swaps from counterparties seeking to sell them, and sell security-based swaps to counterparties seeking to buy them. When SBS Dealers transact as principal risk holders and do not hedge their exposures, they benefit from directional market moves that result in losses

[1587] See Definitions Adopting Release, 77 FR at 30751-30756, supra note 115.

for their counterparties. When SBS Dealers hedge their exposures and do not carry balance sheet risk, they may be indifferent to directional price moves of the security-based swap, but profit from charging high fees to their counterparties, whereas their counterparties benefit from low fees and transaction costs. If SBS Dealers recommend security-based swaps to counterparties, such recommendations may be influenced by the above business incentives. Counterparties of SBS Dealers may be aware of these competing incentives, and SBS Dealers generally benefit from intermediating a greater volume of trades, potentially mitigating these effects. However, informational asymmetries between SBS Dealers and their counterparties outlined above may limit the ability of counterparties to decouple the potential biases and information components of SBS Dealer recommendations, and to evaluate the merits of each security-based swap.

Broadly, these external business conduct rules as adopted may decrease informational asymmetries between SBS Entities and their less sophisticated counterparties and strengthen counterparty protections. This may enable market participants to make better informed investment decisions, and enhance allocative efficiency in security-based swap markets.

The baseline for our economic analysis reflects rules adopted as part of the SBS Entity Definitions Adopting Release, the Cross-Border Adopting Release, Regulation SBSR and SDR Rules,[1588] as well as SBS Entity registration rules. We also recognize that final U.S. Activity rules have been adopted, and affect the scope of cross-border transactions that will become subject to various substantive Title VII requirements,

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[1588] 17 CFR 232.11, 232.101, 232.305, and 232.407; 17 CFR 240.13n-1 to 240.13n-12 ("SDR Rules"). See SDR Registration Release, supra note 1202.

including those related to business conduct standards. While these rules are not yet in effect, to perform a meaningful analysis of the business conduct requirements being adopted and their cross-border application, our baseline includes the final U.S. Activity rules.[1589]

Title VII provides a statutory framework for the OTC derivatives market and divides authority to regulate that market between the CFTC (which regulates swaps) and the Commission (which regulates security-based swaps). We note that many entities expected to register with the Commission as SBS Entities are currently intermediating large volumes of transactions across swap, security-based swap and reference security markets. The Commission has previously estimated that of the total 55 entities expected to register with the Commission as SBS Entities, up to 35 entities are registered with the CFTC as Swap Entities, and up to 16 entities are registered with the Commission as broker-dealers.[1590] Since broker-dealers registered with the Commission and Swap Entities registered with the CFTC are required to join an SRO, the majority of SBS Entities may already be subject to CFTC and SRO oversight. Therefore, we anticipate that many of the entities expected to register as SBS Entities and become subject to the Commission's final business conduct rules may have already brought their business into compliance with CFTC business conduct requirements and SRO rules, among others. The Commission has sought to harmonize, to the extent practicable, the final business conduct requirements with existing requirements applicable to SBS Dealers and broker-dealers. Obligations imposed on SBS Entities in this rulemaking are modeled on, and

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1589 See U.S. Activity Adopting Release, 81 FR at 8598.

1590 See Registration Adopting Release, 80 FR at 49000, supra note 989. Also see U.S. Activity Proposing Release, 80 FR at 27458, supra note 9.

largely similar to, obligations applicable to Swap Entities and registered broker-dealers. These obligations include disclosure, know-your-customer, suitability, pay-to-play, supervision, and compliance responsibilities. The Commission has also considered the implications of certain business conduct rules regarding special entities subject to ERISA. DOL staff has stated that the final business conduct standards neither conflict with DOL regulations nor compel SBS Entities to engage in fiduciary conduct, as discussed in Section II.D supra.

As discussed in the economic baseline, extensive cross-market participation of dealers and non-dealer counterparties in swap, security-based swap and reference security markets points to a high degree of market integration. The Commission has sought to harmonize, to the extent practicable, final business conduct requirements with other existing rules, which may result in efficiencies and lower incremental economic costs for cross-registered SBS Entities and their counterparties than might have otherwise resulted.[1591]

Nonetheless, the Commission recognizes – as reflected in the economic analysis – that the final rules establish new requirements applicable to SBS Entities, and that complying with these requirements will entail costs to SBS Entities. In considering the economic consequences of these final rules we have been mindful of the direct and indirect costs these rules will impose on market participants, as well as the effect of

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[1591] A number of commenters recommended the Commission to harmonize external business conduct rules with those of the CFTC. See, e.g., Barnard, supra note 5; Levin, supra note 5; APPA, supra note 5; BlackRock, supra note 5; NABL, supra note 5; Nomura, supra note 5; AFGI (July 2013), supra note 5; ISDA (July 2013), supra note 5; Barnard (July 2015), supra note 10; and SIFMA (August 2015), supra note 5.

various business conduct requirements on the ability of counterparties to transact with SBS Entities. We have considered the likely costs and benefits of the final business conduct requirements for SBS Entities, counterparties in security-based swap markets, investors in reference security markets, as well as stakeholders in special entities, such as taxpayers, pension holders, endowment beneficiaries, and investors in municipal securities. We have also considered how various types of market participants may respond to the obligations and safe harbors in these final rules.

Some of these final rules impose requirements on SBS Dealers only, whereas others apply to transactions by both SBS Dealers and Major SBS Participants. These final rules have considered potential differences between the roles SBS Dealers and Major SBS Participants in security-based swap markets. As discussed in the sections that follow, registered SBS Dealers are expected to intermediate large volumes of security-based swaps and to transact with many hundreds or thousands of counterparties, whereas Major SBS Participants will be holding significant positions in SBS without intermediating significant volumes of deals.[1592] As discussed in Regulation SBSR, SBS Dealers manage large changes in exposure to reference entities (inventory risk).[1593] Large CDS transactions on a particular reference entity create large inventory positions that affect SBS Dealers' exposure to the credit risk of reference assets. SBS Dealers may actively manage inventory risks that they do not want to bear by entering into offsetting contracts that diversify or hedge new risk exposures. Doing so requires finding market participants, typically in the interdealer market, who are willing to act as

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1592 See Definitions Adopting Release, 77 FR at 30751-30756, supra note 115.

1593 See Regulation SBSR Adopting Release, 80 FR at 14617, infra note 1602.

counterparties to these offsetting contracts.[1594] Further, as discussed above, SBS Dealers observe order flow and may be involved in arranging or structuring security-based swaps, enjoying informational advantages relative to their non-dealer counterparties. In contrast, participants required to register as Major SBS Participants will have accumulated large positions in security-based swaps but have dealing activity below the de minimis threshold. As a result of their substantial positions, Major SBS Participants may be susceptible to market risks. We have considered these differences in risks arising from the security-based swap activity of the two types of SBS Entities.

We have also taken into account comments regarding the different application of various business conduct requirements to SBS Dealers and Major SBS Participants,[1595] including one comment that imposition of "dealer-like" obligations on Major SBS Participants may undermine market development, and reduce competition and counterparty choice.[1596] The Commission recognizes that SBS Dealers serve as the points of connection in security-based swap markets, whereas Major SBS Participants may have greater market impacts and risks associated with holding larger security-based swap positions. As discussed in Section II, these final rules are intended to provide counterparty protections and reduce information asymmetries. The Commission is

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1594 See "Inventory risk management by dealers in the single-name credit default swap market" (October 17, 2014) at 5, available at http://www.sec.gov/comments/s7-34-10/s73410-184.pdf. The analysis uses DTCC-TIW data to describe how SBS Dealers manage inventory risk by hedging. Also see FN14 citing to Hansch, Oliver, Narayan Y. Naik, and S. Viswanathan. "Do inventories matter in dealership markets? Evidence from the London Stock Exchange." The Journal of Finance 53, no. 5 (1998): 1623-1656

1595 See, e.g., MFA, supra note 5; Blackrock, supra note 5; CFA, supra note 5.

1596 See MFA, supra note 5.

imposing counterparty status verification, disclosure, fair and balanced communications, supervision, antifraud, CCO rules and rules related to counterparties of special entities on both SBS Dealers and Major SBS Participants. The final rules limit the scope of "know your counterparty", suitability, pay to play and certain special entity rules to SBS Dealers. Therefore, counterparties of Major SBS Participants, as well as counterparties of SBS Dealers, may benefit from counterparty protections and information benefits of these final rules. At the same time, Major SBS Participants will not be subject to the full range of business conduct obligations where business conduct requirements are not expressly addressed by the Dodd-Frank Act or the statute applies a requirement only to SBS Dealers. We further discuss these considerations in the sections that follow.

We recognize that costs of rules imposed on Major SBS Participants may be passed on to counterparties in the form of transaction costs or a decreased willingness to intermediate transactions with non-SBS or Swap Entity counterparties. As reflected in the economic baseline, the Commission estimates that of the 55 SBS Entities that may register with the Commission, between zero and five entities may be Major SBS Participants. The Commission also estimates that non-SBS Entity counterparties may transact with a median of three and an average of four SBS Dealers per year. Should Major SBS Participants become less willing to transact with non-SBS or Swap Entity counterparties, SBS Dealers are likely to step in to intermediate OTC trades. As articulated in prior sections, the Commission believes that imposing certain final business conduct rules on both SBS Dealers and Major SBS Participants may reduce information asymmetries and enhance counterparty protections in security-based swap markets.

Final business conduct rules reflect the informational advantage of SBS Entities relative to other market participants. SBS Dealers enjoy informational advantages over their non-SBS Entity counterparties. As we quantify in the economic baseline, inter-dealer transactions play a significant role in security-based swap markets, and security-based swap activity is highly concentrated among a small number of dealers. SBS Dealers observe deal flow, and may act in other capacities, such as in the capacity of underwriters or arrangers, in relation to reference securities underlying security-based swaps. Major SBS Participants may also be better informed about the risks and valuations of security-based swaps due to their large positions in security-based swaps. Therefore, compared to other counterparties, both SBS Dealers and Major SBS Participants may be better informed and better able to assess material risks and characteristics of security-based swaps. Final disclosure and suitability rules are limited to security-based swap activities between SBS Entities and counterparties that are not themselves SBS or Swap Entities. Other external business conduct rules explicitly address conduct of SBS Entities when they act as counterparties or advisors to special entities, such as employee benefit plans, municipalities and endowments.

The Commission has considered counterparty protections, information asymmetries and risks arising from arm's length and inter-affiliate transactions. Inter-affiliate transactions may be conducted for the purposes of internal risk management within a commonly controlled corporate group with generally aligned incentives and few informational asymmetries, and may involve the same personnel acting in or on behalf of both parties. Imposing business conduct requirements on transactions among various control affiliates of the same SBS Entity is less likely to result in counterparty

protections, informational benefits or improvements in allocative efficiency, but would result in additional costs and execution delays for SBS Entities.[1597] Similar to the CFTC's adopted approach, the final business conduct rules 240.15Fh-3(a)-(f), 240.15Fh-4(b), and 240.15F-5 will apply to arm's length transactions and exclude transactions that SBS Entities enter into with their majority-owned affiliates.

The Commission notes that, where possible, it has attempted to quantify the costs, benefits, and effects on efficiency, competition, and capital formation expected to result from adopting these rules. In many cases, however, the Commission is unable to quantify the economic effects. Crucially, many of the relevant economic effects, such as counterparty protections, information asymmetry, the ability of less informed market participants to overcome information asymmetries, and the value of Commission enforcement and oversight, are inherently difficult to quantify. In other cases, we lack the information necessary to provide reasonable estimates. For example, we lack data on business conduct practices of U.S. SBS Entities' foreign branches; profitability of SBS Dealer and Major SBS Participant transactions at various volume levels, by type (SEF execution versus OTC/bespoke) and by counterparty (other SBS and Swap Entities, special entities, all other counterparties); the magnitude of the conflicts of interest related to the "pay to play" practices by SBS Entities with respect to special entities and the degree of reliance of dually registered SBS Entities on covered associates already subject to similar prohibitions; and how SBS Entities, new entrants,

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[1597] As discussed in Section II.A, supra, all commenters recommended not applying these final rules to inter-affiliate transactions. See ABA Securities Association, supra note 5; FIA/ISDA/SIFMA, supra note 5; SIFMA (August 2015), supra note 5.

and counterparties, including those currently not transacting in security-based swap markets, may react to specific business conduct rules. To the best of our knowledge, no such data are publicly available and commenters have not provided data to allow such quantification.

B. Baseline

To assess the economic impact of the final rules described in this release, we are using as our baseline the security-based swap market as it exists at the time of this release, including applicable rules we have already adopted but excluding rules that we have proposed but not yet finalized.[1598] The analysis includes the statutory provisions that currently govern the security-based swap market pursuant to the Dodd-Frank Act, and rules adopted in the Definitions Adopting Release, the Cross-Border Adopting Release,[1599] the SDR Registration Release,[1600] the SBS Entity Registration Adopting Release,[1601] and the Regulation SBSR Adopting Release,[1602] along with U.S. Activity rules,[1603] as these final rules—even if compliance is not yet required —are part of the existing regulatory landscape that market participants expect to govern their security-based swap activity.

1598 We also considered, where appropriate, the impact of rules and technical standards promulgated by other regulators, such as the CFTC and the European Securities and Markets Authority, on practices in the security-based swap market.

1599 See Cross-Border Adopting Release, supra note 684.

1600 See SDR Registration Release, supra note 1202.

1601 See Registration Adopting Release, supra note 989.

1602 See "Regulation SBSR-Reporting and Dissemination of Security-Based Swap Information," Exchange Act Release No. 74244 (Feb. 11, 2015), 80 FR 14563 (Mar. 19, 2015) ("Regulation SBSR Adopting Release").

1603 See U.S. Activity Adopting Release 81 FR 8598.

The business conduct rules include a variety of standards for conduct by SBS Entities when they transact with counterparties. While certain requirements apply to SBS Entity transactions with all counterparties, some requirements will affect only SBS Entity transactions with non-SBS or Swap Entities, others distinguish between SBS Dealers and Major SBS Participants, and yet others offer relief for anonymous transactions. The following sections describe current security-based swap market activity, participants, common dealing structures, counterparties, and patterns of cross-border and cross-market participation.

1. Available Data Regarding Security-Based Swap Activity

Our understanding of the market is informed in part by available data on security-based swap transactions, though we acknowledge that limitations in the data limit the extent to which we can quantitatively characterize the market. [1604] Because these data do not cover the entire market, we have developed an understanding of market activity using a sample of transactions data that includes only certain portions of the market. We believe, however, that the data underlying our analysis here provide reasonably comprehensive information regarding single-name CDS transactions and the composition of participants in the single-name CDS market.

Specifically, our analysis of the state of the current security-based swap market is based on data obtained from the DTCC Derivatives Repository Limited Trade Information Warehouse ("TIW"), especially data regarding the activity of market

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[1604] We also rely on qualitative information regarding market structure and evolving market practices provided by commenters, both in letters and in meetings with Commission staff, and knowledge and expertise of Commission staff.

participants in the single-name CDS market during the period from 2008 to 2014. According to data published by the Bank for International Settlements ("BIS"), the global notional amount outstanding in single-name CDS was approximately $9.04 trillion,[1605] in multi-name index CDS was approximately $6.75 trillion, and in multi-name, non-index CDS was approximately $611 billion. The total gross market value outstanding in single-name CDS was approximately $366 billion, and in multi-name CDS instruments was approximately $227 billion.[1606] The global notional amount outstanding in equity forwards and swaps as of December 2014 was $2.50 trillion, with total gross market value of $177 billion.[1607] As these figures show (and as we have previously noted), although the definition of security-based swaps is not limited to single-name CDS, single-name CDS contracts make up a majority of security-based swaps, and we believe that the single-name CDS data are sufficiently representative of the market to inform our analysis of the state of the current security-based swap market.[1608]

1605 The global notional amount outstanding represents the total face amount used to calculate payments under outstanding contracts. The gross market value is the cost of replacing all open contracts at current market prices.

1606 See semi-annual OTC derivatives statistics at December 2014, Table 19, available at http://www.bis.org/statistics/dt1920a.pdf (accessed Jul. 29, 2015).

1607 These totals include both swaps and security-based swaps, as well as products that are excluded from the definition of "swap," such as certain equity forwards.

1608 While other repositories may collect data on transactions in total return swaps on equity and debt, we do not currently have access to such data for these products (or other products that are security-based swaps). Consistent with the Cross-Border Proposing Release, we believe that data related to single-name CDS provide reasonably comprehensive information for purposes of this analysis, as such transactions appear to constitute roughly 74 percent of the security-based swap market as measured on the basis of gross notional outstanding. See Cross-Border Proposing Release, 78 FR 31120 n.1301.

Also consistent with our approach in that release, with the exception of the analysis regarding the degree of overlap between participation in the single-name

We note that the data available to us from TIW do not encompass those CDS transactions that both: (i) do not involve U.S. counterparties;[1609] and (ii) are based on non-U.S. reference entities. Notwithstanding this limitation, the TIW data should provide sufficient information to permit us to identify the types of market participants active in the security-based swap market and the general pattern of dealing within that market.[1610]

2. Security-Based Swap Market: Market Participants and Dealing Structures

a. Security-Based Swap Market Participants

Activity in the security-based swap market is concentrated among a relatively small number of entities that act as dealers in this market. In addition to these entities,

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CDS market and the index CDS market (cross-market activity), our analysis below does not include data regarding index CDS as we do not currently have sufficient information to classify index CDS as swaps or security-based swaps.

1609 Following publication of the Warehouse Trust Guidance on CDS data access, TIW surveyed market participants, asking for the physical address associated with each of their accounts (i.e., where the account is organized as a legal entity). This physical address is designated the registered office location by TIW. When an account reports a registered office location, we have assumed that the registered office location reflects the place of domicile for the fund or account. When an account does not report a registered office location, we have assumed that the settlement country reported by the investment adviser or parent entity to the fund or account is the place of domicile. Thus, for purposes of this analysis, we have classified accounts as "U.S. counterparties" when they have reported a registered office location in the United States. We note, however, that this classification is not necessarily identical in all cases to the definition of "U.S. person" under Exchange Act rule 3a71-3(a)(4).

1610 The challenges we face in estimating measures of current market activity stem, in part, from the absence of comprehensive reporting requirements for security-based swap market participants. The Commission has adopted rules regarding trade reporting, data elements, and public reporting for security-based swaps that are designed to, when fully implemented, provide the Commission with additional measures of market activity that will allow us to better understand and monitor activity in the security-based swap market. See Regulation SBSR Adopting Release, 80 FR at 14699-14700, supra note 1602.

thousands of other participants appear as counterparties to security-based swap contracts in our sample, and include, but are not limited to, investment companies, pension funds, private (hedge) funds, sovereign entities, and industrial companies. We observe that most non-dealer users of security-based swaps do not engage directly in the trading of swaps, but trade through banks, investment advisers, or other types of firms acting as dealers or agents. Based on an analysis of the counterparties to trades reported to the TIW, there are 1,875 entities that engaged directly in trading between November 2006 and December 2014.[1611]

As shown in Table 1, below, close to three-quarters of these entities (DTCC-defined "firms" shown in TIW, which we refer to here as "transacting agents") were identified as investment advisers, of which approximately 40 percent (about 30 percent of all transacting agents) were registered as investment advisers under the Advisers Act.[1612] Although investment advisers comprise the vast majority of transacting agents, the transactions they executed account for only 11.5 percent of all single-name CDS trading

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[1611] These 1,875 entities, which are presented in more detail in Table 1, below, include all DTCC-defined "firms" shown in TIW as transaction counterparties that report at least one transaction to TIW as of December 2014. The staff in the Division of Economic and Risk Analysis classified these firms, which are shown as transaction counterparties, by machine matching names to known third-party databases and by manual classification. See, e.g., Cross-Border Proposing Release, 78 FR 31120, n. 1304, supra note 6. Manual classification was based in part on searches of the EDGAR and Bloomberg databases, the SEC's Investment Adviser Public Disclosure database, and a firm's public website or the public website of the account represented by a firm. The staff also referred to ISDA protocol adherence letters available on the ISDA website.

[1612] See 15 U.S.C. 80b1–80b21. Transacting agents participate directly in the security-based swap market, without relying on an intermediary, on behalf of principals. For example, a university endowment may hold a position in a security-based swap that is established by an investment adviser that transacts on the endowment's behalf. In this case, the university endowment is a principal that uses the investment adviser as its transacting agent.

activity reported to the TIW, measured by number of transaction-sides (each transaction has two transaction sides, i.e., two transaction counterparties). The vast majority of transactions (83.7 percent) measured by number of transaction-sides were executed by ISDA-recognized dealers.

Table 1. The number of transacting agents by counterparty type and the fraction of total trading activity, from November 2006 through December 2014, represented by each counterparty type.[1613]

Transacting Agents	Number	Percent	Transaction share
Investment Advisers	1,425	76.0%	11.5%
- SEC registered	*571*	*30.5%*	*7.7%*
Banks	252	13.4%	4.3%
Pension Funds	27	1.4%	0.1%
Insurance Companies	38	2.0%	0.2%
ISDA-Recognized Dealers[1614]	17	0.9%	83.7%
Other	116	6.2%	0.2%
Total	1,875	99.9%	100%

Principal holders of CDS risk exposure are represented by "accounts" in the TIW.[1615] The staff's analysis of these accounts in TIW shows that the 1,875 transacting agents classified in Table 1 represent 10,900 principal risk holders. Table 2, below,

[1613] Adjustments to these statistics reflect updated classifications of counterparties and transactions classification resulting from further analysis of the TIW data.

[1614] For the purpose of this analysis, the ISDA-recognized dealers are those identified by ISDA as belonging to the G14 or G16 dealer group during the period: JP Morgan Chase NA (and Bear Stearns), Morgan Stanley, Bank of America NA (and Merrill Lynch), Goldman Sachs, Deutsche Bank AG, Barclays Capital, Citigroup, UBS, Credit Suisse AG, RBS Group, BNP Paribas, HSBC Bank, Lehman Brothers, Société Générale, Credit Agricole, Wells Fargo and Nomura. See, e.g., http://www.isda.org/c_and_a/pdf/ISDA-Operations-Survey-2010.pdf.

[1615] "Accounts" as defined in the TIW context are not equivalent to "accounts" in the definition of "U.S. person" provided by Exchange Act rule 3a71-3(a)(4)(i)(C). They also do not necessarily represent separate legal persons. One entity or legal person may have multiple accounts. For example, a bank may have one DTCC account for its U.S. headquarters and one DTCC account for one of its foreign branches.

classifies these principal risk holders by their counterparty type and whether they are represented by a registered or unregistered investment adviser.[1616] For instance, banks in Table 1 allocated transactions across 327 accounts, of which 23 were represented by investment advisers. In the remaining 304 instances, banks traded for their own accounts. Meanwhile, ISDA-recognized dealers in Table 1 allocated transactions across 75 accounts.

[1616] Unregistered investment advisers include all investment advisers not registered under the Investment Advisers Act and may include investment advisers registered with a state or a foreign authority.

Table 2. The number and percentage of account holders—by type—who participate in the security-based swap market through a registered investment adviser, an unregistered investment adviser, or directly as a transacting agent, from November 2006 through December 2014. [1617]

Account Holders by Type	Number	Represented by a registered investment adviser		Represented by an unregistered investment adviser		Participant is transacting agent[1618]	
Private Funds	3,168	1,569	50%	1,565	49%	34	1%
DFA Special Entities	1,141	1,088	95%	33	3%	20	2%
Registered Investment Companies	800	768	96%	30	4%	2	0%
Banks (non-ISDA-recognized dealers)	327	17	5%	6	2%	304	93%
Insurance Companies	232	150	65%	21	9%	61	26%
ISDA-Recognized Dealers	75	0	0%	0	0%	75	100%
Foreign Sovereigns	72	53	74%	3	4%	16	22%
Non-Financial Corporations	61	43	70%	3	5%	15	25%
Finance Companies	13	6	46%	0	0%	7	54%
Other/Unclassified	5,011	3,327	66%	1,452	29%	232	5%
All	10,900	7,021	64%	3,113	29%	766	7%

Among the accounts, there are 1,141 Dodd-Frank Act-defined special entities[1619] and 800 investment companies registered under the Investment Company Act of 1940.[1620]

[1617] Adjustments to these statistics reflect updated classifications of counterparties and transactions classification resulting from further analysis of the TIW data.

[1618] This column reflects the number of participants who are also trading for their own accounts.

[1619] Our manual classification does not distinguish between special entities subject to ERISA and special entities defined in, but not subject to ERISA, and this estimate includes both groups of entities. Therefore, our analysis includes entities that may opt out of the special entity status under these final rules. If many such entities

Private funds comprise the largest type of account holders that we were able to classify, and although not verified through a recognized database, most of the funds we were not able to classify appear to be private funds.[1621]

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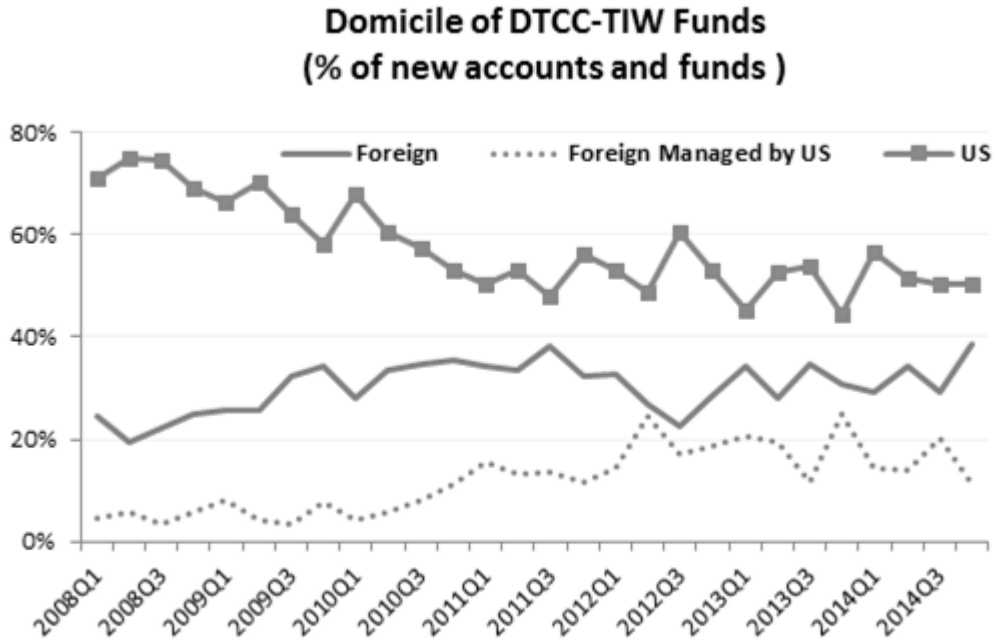
opt out, this figure may overestimate the number of market participants subject to business conduct standards with regards to special entities. See Section VI.C.4.

[1620] See 15 U.S.C. 80a1–80a64. There remain approximately 5,000 DTCC "accounts" unclassified by type. Although unclassified, each was manually reviewed to verify that it was not likely to be a special entity within the meaning of the Dodd-Frank Act and instead was likely to be an entity such as a corporation, an insurance company, or a bank.

[1621] For the purposes of this discussion, "private fund" encompasses various unregistered pooled investment vehicles, including hedge funds, private equity funds, and venture capital funds.

Figure 1: The percentage of (1) new accounts with a domicile in the United States (referred to as "US"), (2) new accounts with a domicile outside the United States that are associated with a firm that also has a domicile outside the United States (referred to below as "Foreign"), and (3) new accounts with a domicile outside the United States that are associated with a firm that has a domicile in the United States, (collectively referred to below as "Foreign Managed by US").[1622] Unique new accounts are aggregated, and percentages are computed, on a quarterly basis, from January 2008 through December 2014.



b. <u>Participant Domiciles</u>

As depicted in Figure 1 above, domiciles of new accounts participating in the market have shifted over time. It is unclear whether these shifts represent changes in the types of participants active in this market, changes in reporting or changes in transaction volumes in particular underliers. For example, the increased percentage of new entrants that are foreign accounts may reflect an increase in participation by foreign account

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1622 See Section VI.B.1, supra (explaining how domiciles for firms were identified for purposes of this analysis).

holders in the security-based swap market, and the increased percentage of the subset of new entrants that are foreign accounts managed by U.S. persons also may reflect more specifically the flexibility with which market participants can restructure their market participation in response to regulatory intervention, competitive pressures, and other stimuli.[1623] On the other hand, apparent changes in the percentage of new accounts with foreign domiciles may reflect improvements in reporting by market participants to TIW, an increase in the percentage of transactions between U.S. and non-U.S. counterparties, and/or increased transactions in single-name CDS on U.S. reference entities by foreign persons.[1624]

c. Market Centers

A market participant's domicile, however, does not necessarily correspond to where it engages in security-based swap activity. In particular, financial groups engaged in security-based swap dealing activity operate in multiple market centers and carry out such activity with counterparties around the world.[1625] Several commenters noted that many market participants that are engaged in dealing activity prefer to use traders and manage risk for security-based swaps in the jurisdiction where the underlier is traded. Thus, although a significant amount of the dealing activity in security-based swaps on

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1623 See Charles Levinson, "U.S. banks moved billions in trades beyond the CFTC's reach," Reuters (Aug. 21, 2015), available at: http://www.reuters.com/article/2015/08/21/usa-banks-swaps-idUSL3N10S57R20150821.

1624 As noted above, the available data do not include all security-based swap transactions but only transactions in single name CDS that involve either (1) at least one account domiciled in the United States (regardless of the reference entity) or (2) single-name CDS on a U.S. reference entity (regardless of the U.S.-person status of the counterparties).

1625 See U.S. Activity Proposing Release, 80 FR 27449-27452, supra note 9.

U.S. reference entities involves non-U.S. dealers, we understand that these dealers tend to carry out much of the security-based swap trading and related risk-management activities in these security-based swaps within the United States.[1626] Some dealers have explained that being able to centralize their trading, sales, risk management and other activities related to U.S. reference entities in U.S. operations (even when the resulting transaction is booked in a foreign entity) improves the efficiency of their dealing business.

Consistent with these operational concerns and the global nature of the security-based swap market, the available data appear to confirm that participants in this market are in fact active in market centers around the globe. Although, as noted above, the available data do not permit us to identify the location of personnel in a transaction, TIW transaction records indicate that firms that are likely to be security-based swap dealers operate out of branch locations in key market centers around the world, including New York, London, Tokyo, Hong Kong, Chicago, Sydney, Toronto, Frankfurt, Singapore and the Cayman Islands.[1627]

Given these market characteristics and practices, participants in the security-based swap market may bear the financial risk of a security-based swap transaction in a location different from the location where the transaction is arranged, negotiated, or executed, or where economic decisions are made by managers on behalf of beneficial owners. Market activity may also occur in a jurisdiction other than where the market participant or its counterparty books the transaction. Similarly, a participant in the

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1626 See id.

1627 TIW transaction records contain a proxy for the domicile of an entity, which may differ from branch locations, which are separately identified in the transaction records.

security-based swap market may be exposed to counterparty risk from a counterparty located in a jurisdiction that is different from the market center or centers in which it participates.

d. Common Business Structures for Firms Engaged in Security-Based Swap Dealing Activity

A financial group that engages in a global security-based swap dealing business in multiple market centers may choose to structure its dealing business in a number of different ways. This structure, including where it books the transactions that constitute that business and how it carries out market-facing activities that generate those transactions, reflects a range of business and regulatory considerations, which each financial group may weigh differently.

A financial group may choose to book all of its security-based swap transactions, regardless of where the transaction originated, in a single, central booking entity. That entity generally retains the risk associated with that transaction, but it also may lay off that risk to another affiliate via a back-to-back transaction or an assignment of the security-based swap.[1628] Alternatively, a financial group may book security-based swaps arising from its dealing business in separate affiliates, which may be located in the jurisdiction where it originates the risk associated with the security-based swap, or, alternatively, the jurisdiction where it manages that risk. Some financial groups may

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[1628] See U.S. Activity Proposing Release, 80 FR 27463, supra note 9; Cross-Border Proposing Release, 78 FR 30977-78, supra note 6.

book transactions originating in a particular region to an affiliate established in a jurisdiction located in that region.[1629]

Regardless of where a financial group determines to book its security-based swaps arising out of its dealing activity, it is likely to operate offices that perform sales or trading functions in one or more market centers in other jurisdictions. Maintaining sales and trading desks in global market centers permits the financial group to deal with counterparties in that jurisdiction or in a specific geographic region, or to ensure that it is able to provide liquidity to counterparties in other jurisdictions,[1630] for example, when a counterparty's home financial markets are closed. A financial group engaged in a security-based swap dealing business also may choose to manage its trading book in particular reference entities or securities primarily from a trading desk that can take advantage of local expertise in such products or that can gain access to better liquidity, which may permit it to more efficiently price such products or to otherwise compete more effectively in the security-based swap market. Some financial groups prefer to centralize risk management, pricing, and hedging for specific products with the personnel responsible for carrying out the trading of such products to mitigate operational risk associated with transactions in those products.

1629 There is some indication that this booking structure is becoming increasingly common in the market. See, e.g., "Regional swaps booking replacing global hubs," Risk.net (Sep. 4, 2015), available at: http://www.risk.net/risk-magazine/feature/2423975/regional-swaps-booking-replacing-global-hubs. Such a development may be reflected in the increasing percentage of new entrants that have a foreign domicile, as described above.

1630 These offices may be branches or offices of the booking entity itself, or branches or offices of an affiliated agent, such as, in the United States, a registered broker-dealer.

The financial group affiliate that books these transactions may carry out related market-facing activities, whether in its home jurisdiction or in a foreign jurisdiction, using either its own personnel or the personnel of an affiliated or unaffiliated agent. For example, the financial group may determine that another affiliate in the financial group employs personnel who possess expertise in relevant products or who have established sales relationships with key counterparties in a foreign jurisdiction, making it more efficient to use the personnel of the affiliate to engage in security-based swap dealing activity on its behalf in that jurisdiction. In these cases, the affiliate that books these transactions and its affiliated agent may operate as an integrated dealing business, each performing distinct core functions in carrying out that business.

Alternatively, the financial group affiliate that books these transactions may in some circumstances, determine to engage the services of an unaffiliated agent through which it can engage in dealing activity. For example, a financial group may determine that using an interdealer broker may provide an efficient means of participating in the interdealer market in its own, or in another, jurisdiction, particularly if it is seeking to do so anonymously or to take a position in products that trade relatively infrequently.[1631] A financial group may also use unaffiliated agents that operate at its direction. Such an arrangement may be particularly valuable in enabling a financial group to service clients or access liquidity in jurisdictions in which it has no security-based swap operations of its own.

[1631] We understand that interdealer brokers may provide voice or electronic trading services that, among other things, permit dealers to take positions or hedge risks in a manner that preserves their anonymity until the trade is executed. These interdealer brokers also may play a particularly important role in facilitating transactions in less-liquid security-based swaps.

We understand that financial group affiliates (whether affiliated with U.S.-based financial groups or not) that are established in foreign jurisdictions may use any of these structures to engage in dealing activity in the United States, and that they may seek to engage in dealing activity in the United States to transact with both U.S.-person and non-U.S.-person counterparties. In transactions with non-U.S.-person counterparties, these foreign affiliates may affirmatively seek to engage in dealing activity in the United States because the sales personnel of the non-U.S.-person dealer (or of its agent) in the United States have existing relationships with counterparties in other locations (such as Canada or Latin America) or because the trading personnel of the non-U.S.-person dealer (or of its agent) in the United States have the expertise to manage the trading books for security-based swaps on U.S. reference securities or entities. We understand that some of these foreign affiliates engage in dealing activity in the United States through their personnel (or personnel of their affiliates) in part to ensure that they are able to provide their own counterparties, or those of financial group affiliates in other jurisdictions, with access to liquidity (often in non-U.S. reference entities) during U.S. business hours, permitting them to meet client demand even when the home markets are closed. In some cases, such as when seeking to transact with other dealers through an interdealer broker, these foreign affiliates may act, in a dealing capacity, in the United States through an unaffiliated, third-party agent.

e. Current Estimates of Number of SBS Dealers and Major SBS Participants

As discussed above, security-based swap activity is concentrated in a relatively small number of dealers, which already represent a small percentage of all market participants active in the security-based swap market. Based on analysis of 2014 data,

our earlier estimates of the number of entities likely to register as security-based swap dealers remain largely unchanged.[1632] Of the approximately 50 entities that we estimate may potentially register as security-based swap dealers, we believe it is reasonable to expect 22 to be non-U.S. persons.[1633] Under the rules as they currently exist, we identified approximately 170 entities engaged in single-name CDS activity, with all counterparties, of $2 billion or more. Of those entities, 155 would be expected to incur assessment costs to determine whether they meet the "security-based swap dealer" definition. Approximately 57 of these entities are non-U.S. persons.

Many of these dealers are already subject to other regulatory frameworks under U.S. law based on their role as intermediaries or on the volume of their positions in other products, such as swaps. Available data supports our prior estimates, based on our experience and understanding of the swap and security-based swap market that of the 55 firms that might register as SBS Dealers or Major SBS Participants, approximately 35 would also be registered with the CFTC as Swap Dealers or Major Swap Participants.[1634]

1632 See Registration Adopting Release, 80 FR 49000, supra note 989.

1633 These estimates are based on the number of accounts in TIW data with total notional volume in excess of de minimis thresholds, increased by a factor of two, to account for any potential growth in the security-based swap market, to account for the fact that we are limited in observing transaction records for activity between non-U.S. persons to those that reference U.S. underliers, and to account for the fact that we do not observe security-based swap transactions other than in single-name CDS. See U.S. Activity Proposing Release, 80 FR 27452, supra note 9. See also Definitions Adopting Release, 77 FR 30725, n.1457, supra note 115.

1634 Based on our analysis of 2014 TIW data and the list of swap dealers provisionally registered with the CFTC, and applying the methodology used in the Definitions Adopting Release, we estimate that substantially all registered security-based swap dealers would also be registered as swap dealers with the CFTC. See U.S. Activity Proposing Release, 80 FR 27458, supra note 9; Registration Adopting Release, 80 FR 49000, supra note 989. See also CFTC list of provisionally

Based on our analysis of TIW data and filings with the Commission, we estimate that 16 market participants expected to register as SBS Dealers have already registered with the Commission as broker-dealers and are thus subject to Exchange Act and FINRA requirements applicable to such entities. Finally, as we discuss below, some dealers may be subject to similar requirements in one or more foreign jurisdictions.

3. Security-Based Swap Market: Levels of Security-Based Swap Trading Activity

As already noted, firms that act as dealers play a central role in the security-based swap market. Based on an analysis of 2014 single name CDS data in TIW, accounts of those firms that are likely to exceed the SBS Dealer de minimis thresholds and trigger registration requirements intermediated transactions with a gross notional amount of approximately $8.5 trillion, over 60 percent of which was intermediated by top 5 dealer accounts.[1635]

These dealers transact with hundreds or thousands of counterparties. Approximately 35 percent of accounts of firms expected to register as SBS Dealers and observable in TIW have entered into security-based swaps with over 1,000 unique counterparty accounts as of year-end 2014.[1636] Approximately 9 percent of these

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registered swap dealers, available at: http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.

1635 Commission staff analysis of TIW transaction records indicates that approximately 99 percent of single name CDS price-forming transactions in 2014 involved an ISDA-recognized dealer.

1636 Many dealer entities and financial groups transact through numerous accounts. Given that individual accounts may transact with hundreds of counterparties, we may infer that entities and financial groups, which may have multiple accounts, transact with at least as many counterparties as the largest of their accounts in terms of number of counterparties.

accounts transacted with 500-1,000 unique counterparty accounts; another 35 percent transacted with 100-500 unique accounts, and only 22 percent of these accounts intermediated swaps with fewer than 100 unique counterparties in 2014. The median dealer account transacted with 453 unique accounts (with an average of approximately 759 unique accounts). Non-dealer counterparties transact almost exclusively with these dealers. The median non-dealer counterparty transacted with 3 dealer accounts (with an average of approximately 4 dealer accounts) in 2014.

Figure 2 below describes the percentage of global, notional transaction volume in North American corporate single-name CDS reported to the TIW between January 2008 and December 2014, separated by whether transactions are between two ISDA-recognized dealers (interdealer transactions) or whether a transaction has at least one non-dealer counterparty.

Figure 2 also shows that the portion of the notional volume of North American corporate single-name CDS represented by interdealer transactions has remained fairly constant and that interdealer transactions continue to represent a significant majority of trading activity even as notional volume has declined over the past six years,[1637] from more than $6 trillion in 2008 to less than $3 trillion in 2014.[1638] The high level of interdealer trading activity reflects the central position of a small number of dealers, each of which intermediates trades with many hundreds of counterparties. While we are

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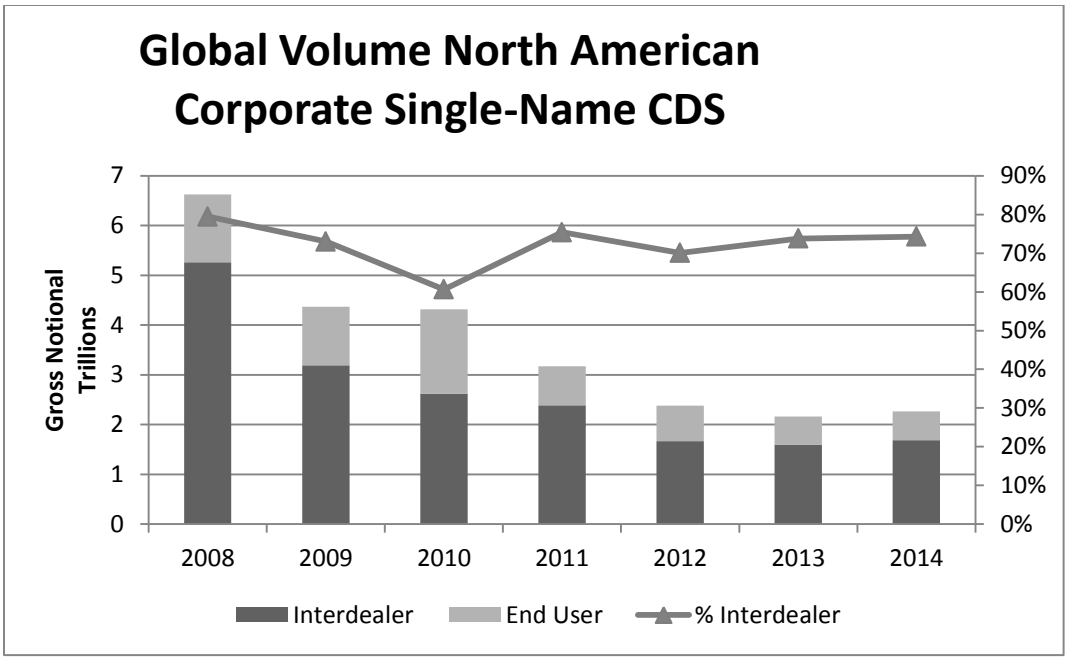
1637 The start of this decline predates the enactment of the Dodd-Frank Act and the proposal of rules thereunder, which is important to note for the purpose of understanding the economic baseline for this rulemaking.

1638 This estimate is lower than the gross notional amount of $8.5 trillion noted above as it includes only the subset of single-name CDS referencing North American corporate documentation, as discussed above.

unable to quantify the current level of trading costs for single-name CDS, those dealers appear to enjoy market power as a result of their small number and the large proportion of order flow they privately observe.

Figure 2: Global, notional trading volume in North American corporate single-name CDS by calendar year and the fraction of volume that is interdealer. [1639]



Against this backdrop of declining North American corporate single-name CDS activity, about half of the trading activity in North American corporate single-name CDS reflected in the set of data we analyzed was between counterparties domiciled in the United States and counterparties domiciled abroad, as shown in Figure 3 below. Using the self-reported registered office location of the TIW accounts as a proxy for domicile,

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1639 Adjustments to these statistics from the proposal reflect additional analysis of TIW data. Cf. Registration Adopting Release, 80 FR 49001, supra note 989 (showing slightly different values for 2012 through 2014). For the purposes of this analysis, we assume that same-day cleared transactions reflect inter-dealer activity.

we estimate that only 12 percent of the global transaction volume by notional volume between 2008 and 2014 was between two U.S.-domiciled counterparties, compared to 48 percent entered into between one U.S.-domiciled counterparty and a foreign-domiciled counterparty and 40 percent entered into between two foreign-domiciled counterparties.[1640]

If we consider the number of cross-border transactions instead from the perspective of the domicile of the corporate group (e.g., by classifying a foreign bank branch or foreign subsidiary of a U.S. entity as domiciled in the United States), the percentages shift significantly. Under this approach, the fraction of transactions entered into between two U.S.-domiciled counterparties increases to 32 percent, and to 51 percent for transactions entered into between a U.S.-domiciled counterparty and a foreign-domiciled counterparty.

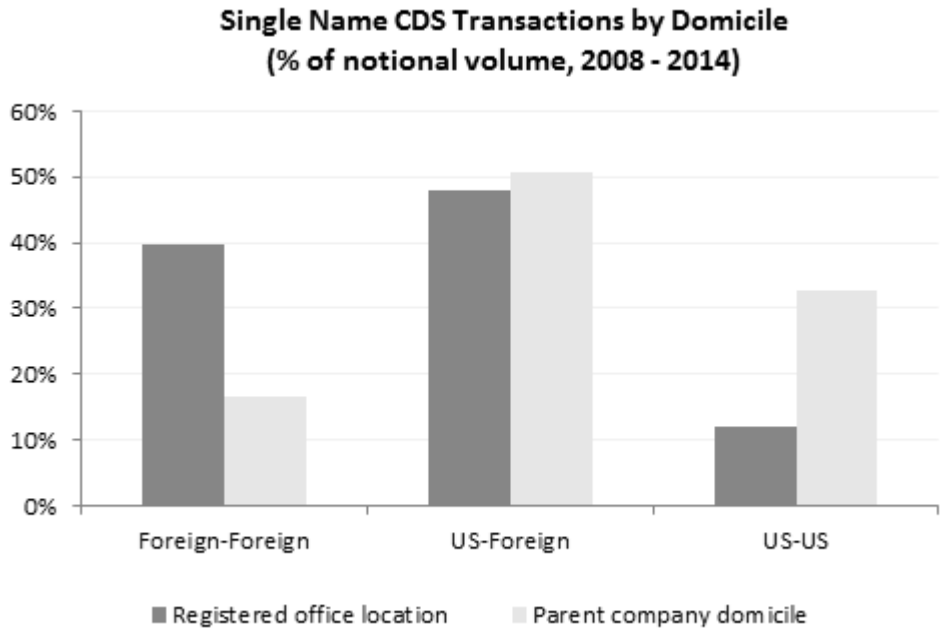
By contrast, the proportion of activity between two foreign-domiciled counterparties drops from 40 percent to 17 percent. This change in respective shares based on different classifications suggests that the activity of foreign subsidiaries of U.S. firms and foreign branches of U.S. banks accounts for a higher percentage of security-based swap activity than U.S. subsidiaries of foreign firms and U.S. branches of foreign banks. It also demonstrates that financial groups based in the United States are involved in an overwhelming majority (approximately 83 percent) of all reported transactions in North American corporate single-name CDS.

[1640] For purposes of this discussion, we have assumed that the registered office location reflects the place of domicile for the fund or account, but we note that this domicile does not necessarily correspond to the location of an entity's sales or trading desk. See U.S. Activity Adopting Release, 81 FR 8607

Financial groups based in the United States are also involved in a majority of interdealer transactions in North American corporate single-name CDS. Of transactions on North American corporate single-name CDS between two ISDA-recognized dealers and their branches or affiliates, 65 percent of transaction notional volume involved at least one account of an entity with a U.S. parent.

In addition, we note that a significant majority of North American corporate single-name CDS transactions occur in the interdealer market or between dealers and non-U.S.-person non-dealers, with the remaining (and much smaller) portion of the market consisting of transactions between dealers and U.S.-person non-dealers. Specifically, 79.5 percent of North American corporate single-name CDS transactions involved either two ISDA-recognized dealers or an ISDA-recognized dealer and a non-U.S.-person non-dealer. Approximately 20 percent of such transactions involved an ISDA-recognized dealer and a U.S.-person non-dealer.

Figure 3: The fraction of notional volume in North American corporate single-name CDS between (1) two U.S.-domiciled accounts, (2) one U.S.-domiciled account and one non-U.S.-domiciled account, and (3) two non-U.S.-domiciled accounts, computed from January 2008 through December 2014.



4. Global Regulatory Efforts

In 2009, leaders of the G20—whose membership includes the United States, 18 other countries, and the European Union ("EU")—addressed global improvements in the OTC derivatives markets. They expressed their view on a variety of issues relating to OTC derivatives contracts. In subsequent summits, the G20 leaders have returned to OTC derivatives regulatory reform and encouraged international consultation in developing standards for these markets.[1641]

Many SBS Dealers likely will be subject to foreign regulation of their security-based swap activities that are similar to regulations that may apply to them pursuant to

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[1641] See, e.g., G20 Leaders' Final Declaration, November 2011, para. 24 available at: https://g20.org/wp-content/uploads/2014/12/Declaration_eng_Cannes.pdf.

Title VII, even if the relevant foreign jurisdictions do not classify certain market participants as "dealers" for regulatory purposes. Some of these regulations may duplicate, and in some cases conflict with, certain elements of the Title VII regulatory framework.

Foreign legislative and regulatory efforts have focused on five general areas: moving OTC derivatives onto organized trading platforms, requiring central clearing of OTC derivatives, requiring post-trade reporting of transaction data for regulatory purposes and public dissemination of anonymized versions of such data, establishing or enhancing capital requirements for non-centrally cleared OTC derivatives transactions, and establishing or enhancing margin and other risk mitigation requirements for non-centrally cleared OTC derivatives transactions. Foreign jurisdictions have been actively implementing regulations in connection with each of these categories of requirements. Regulatory transaction reporting requirements are in force in a number of jurisdictions including the EU, Hong Kong SAR, Japan, Australia, Brazil, Canada, China, India, Indonesia, South Korea, Mexico, Russia, Saudi Arabia, and Singapore; other jurisdictions are in the process of proposing legislation and rules to implement these requirements.[1642] In addition, a number of major foreign jurisdictions have initiated the process of implementing margin and other risk mitigation requirements for non-centrally cleared

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1642 Information regarding ongoing regulatory developments described in this section was primarily obtained from progress reports on implementation of OTC derivatives market reforms published by the Financial Stability Board. These are available at: http://www.financialstabilityboard.org/publications/progress-reports/?policy_area[]=17 .

OTC derivatives transactions.[1643] Several jurisdictions have also taken steps to implement the Basel III recommendations governing capital requirements for financial entities, which include enhanced capital charges for non-centrally cleared OTC derivatives transactions.[1644]

5. Dually Registered Entities

We expect the magnitude of the above economic costs, benefits, and effects on efficiency, competition and capital formation to depend on the extent to which SBS Entities are already complying with similar business conduct rules. As discussed extensively in the baseline and in the sections that follow, most entities expected to register with the Commission and become subject to these final business conduct standards have registered with the CFTC as Swap Entities or with the Commission as

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1643 In November 2015, the Financial Stability Board reported that 12 member jurisdictions participating in its tenth progress report on OTC derivatives market reforms had in force a legislative framework or other authority to require exchange of margin for non-centrally cleared transactions and had published implementing standards or requirements for consultation or proposal. A further 11 member jurisdictions had a legislative framework or other authority in force or published for consultation or proposal. See Financial Stability Board, OTC Derivatives Market Reforms Tenth Progress Report on Implementation (November 2015), available at http://www.financialstabilityboard.org/wp-content/uploads/OTC-Derivatives-10th-Progress-Report.pdf.

1644 In November 2015, the Financial Stability Board reported that 18 member jurisdictions participating in its tenth progress report on OTC derivatives market reforms had in force standards or requirements covering more than 90% of transactions that require enhanced capital charges for non-centrally cleared transactions. A further three member jurisdictions had a legislative framework or other authority in force and had adopted implementing standards or requirements that were not yet in force. An additional three member jurisdictions had a legislative framework or other authority in force or published for consultation or proposal. See Financial Stability Board, OTC Derivatives Market Reforms Tenth Progress Report on Implementation (November 2015), available at http://www.financialstabilityboard.org/wp-content/uploads/OTC-Derivatives-10th-Progress-Report.pdf.

broker-dealers. Therefore, they have already become subject to CFTC's adopted external business conduct rules and/or FINRA rules related to, among others, suitability, communications with the public, supervision, and compliance. The Commission has sought to harmonize the regulatory regimes in recognition of swap and security-based swap market integration and extensive cross-market participation. As a result, some SBS Entities may have already restructured their activities to comply with many of the substantive business conduct standards being adopted. Dually registered SBS Entities that have already restructured their systems and activities to comply with parallel CFTC and FINRA rules may incur lower costs relative to non-dually registered SBS Entities. The specific economic costs, benefits, and effects on efficiency, competition, and capital formation of various business conduct rules and requirements are discussed in further detail in the sections that follow. Wherever practicable, we also evaluate the economic effects of the various rules being adopted against these parallel rules, and other reasonable alternatives.

6. Cross-Market Participation

As noted above, persons registered as SBS Dealers and Major SBS Participants are likely also to engage in swap activity, which is subject to regulation by the CFTC.[1645] This overlap reflects the relationship between single-name CDS contracts, which are security-based swaps, and index CDS contracts, which may be swaps or security-based swaps. A single-name CDS contract covers default events for a single reference entity or reference security. Index CDS contracts and related products make payouts that are

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[1645] See U.S. Activity Adopting Release, 81 FR 8609; Registration Adopting Release, 80 FR 49000, supra note 989.

contingent on the default of index components and allow participants in these instruments to gain exposure to the credit risk of the basket of reference entities that comprise the index, which is a function of the credit risk of the index components. A default event for a reference entity that is an index component will result in payoffs on both single-name CDS written on the reference entity and index CDS written on indices that contain the reference entity. Because of this relationship between the payoffs of single-name CDS and index CDS products, prices of these products depend upon one another,[1646] creating hedging opportunities across these markets.

These hedging opportunities mean that participants that are active in one market are likely to be active in the other. Commission staff analysis of approximately 4,500 TIW accounts that participated in the market for single-name CDS in 2014 revealed that approximately 3,000 of those accounts, or 67 percent, also participated in the market for index CDS. Of the accounts that participated in both markets, data regarding transactions in 2014 suggest that, conditional on an account transacting in notional volume of index CDS in the top third of accounts, the probability of the same account landing in the top third of accounts in terms of single-name CDS notional volume is approximately 64 percent; by contrast, the probability of the same account landing in the bottom third of accounts in terms of single-name CDS notional volume is only 10 percent.[1647]

1646 "Correlation" typically refers to linear relationships between variables; "dependence" captures a broader set of relationships that may be more appropriate for certain swaps and security-based swaps. See, e.g., Casella, George and Roger L. Berger, "Statistical Inference" (2002), at 171.

1647 The Commission recently revised its methodology for estimating cross-market participation of TIW accounts. This has resulted in an increase in the reported number of accounts that participated in both markets relative to previous Commission releases.

Similarly, since the payoffs of security-based swaps are dependent upon the value of underlying securities, activity in the security-based swap market can be correlated with activity in underlying securities markets. Security-based swaps may be used in order to hedge or speculate on price movements of reference securities or the credit risk of reference securities. For instance, prices of both CDS and corporate bonds are sensitive to the credit risk of underlying reference securities. As a result, trading across markets may sometimes result in information and risk spillovers between these markets, with informational efficiency, pricing and liquidity in the security-based swap market affecting informational efficiency, pricing, and liquidity in markets for related assets, such as equities and corporate bonds.[1648]

7. Pay to Play Prohibitions

[1648] See the Registration Adopting Release, 80 FR 49003, supra note 989. Empirical evidence on the direction and significance of the CDS-bond market spillover is mixed. See also Massa and Zhang (2012) Massa & L. Zhang, CDS and the Liquidity Provision in the Bond Market (INSEAD Working Paper No. 2012/114/FIN, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2164675 (considering whether the presence of CDS improves pricing and liquidity of investment grade bonds in 2001-2009); S. Das, M. Kalimipalli & S. Nayak, Did CDS Trading Improve the Market for Corporate Bonds?, 111 J. Fin. Econ. 495 (2014) (considering the effects of CDS trading on the efficiency, pricing error and liquidity of corporate bond markets); M. Oehmke & A. Zawadowski, The Anatomy of the CDS Market, Rev. of Fin. Studies (forthcoming), available at https://www0.gsb.columbia.edu/faculty/moehmke/papers/OehmkeZawadowski_CDS.pdf (suggesting a standardization and liquidity role of CDS markets and documenting cross-market arbitrage links between the CDS market and the bond market); and Boehmer, S. Chava, & H. Tookes, Related Securities and Equity Market Quality: The Cases of CDS, 50(3) J. Fin. & Quant. Analysis (2015), pp 509-541 (providing evidence that firms with traded CDS contracts on their debt experience significantly lower liquidity and price efficiency in equity markets when these firms are closer to default and in times of high market volatility).

The baseline against which we are assessing the potential effects of the pay to play prohibitions in these final business conduct rules reflects MSRB Rules G-37 and G-38, SEC Rule 206(4)-5 under the Advisers Act, as well as CFTC Regulation 23.451. First, we note that MSRB rules G-37 and G-38 are currently effective and are part of the economic baseline. Second, Rule 206(4)-5 prohibits an adviser and its covered associates from providing or agreeing to provide, directly or indirectly, payment to any third party for solicitation of advisory business from any government entity on such adviser's behalf unless such third party is a "regulated person," defined in Rule 206(4)-5 as (i) an SEC-registered investment adviser, (ii) a registered broker or dealer subject to pay-to-play rules adopted by a registered national securities association, or (iii) a registered municipal advisor that is subject to pay-to-play rules adopted by the MSRB ("third-party solicitor ban"). Although the compliance date for the third-party solicitor ban was July 31, 2015, the Division of Investment Management stated that it will not recommend enforcement action to the Commission with respect to the third-party solicitor ban until the later of (1) the effective date of a FINRA pay-to-play rule or (2) the effective date of an MSRB pay-to-play rule for registered municipal advisors.[1649] Therefore, certain parts of Rule 206(4)-5—the prohibition from receiving compensation for advising government entities for two years after certain contributions are made, and the prohibition from coordinating and soliciting contributions to government officials and parties--enter into our economic baseline.

[1649] See "Staff Responses to Questions About the Pay to Play Rule," Question I.4, updated as of Jun. 25, 2015. Available at: https://www.sec.gov/divisions/investment/pay-to-play-faq.htm, last accessed 4/6/2016.

Third, Commodity Exchange Act Rule 23.451 prohibits Swap Dealers from offering to enter or entering into a swap with governmental special entities within two years of any contribution to an official of such entity by the Swap Dealer or any covered associate. The CFTC has similarly stated that the rule is intended to deter fraud and undue influence that harms the public, and to promote consistency in the business conduct standards that apply to financial market professionals dealing with municipal entities. However, CFTC Letter No. 12-33 provided no-action relief from Regulation 23.451 to Swap Dealers and their covered associates with respect to "governmental plans" defined in Section 3 of ERISA, to the extent that such plans are not otherwise covered by SEC and/or MSRB rules. The CFTC has also clarified that the two year "look-back" period does not include any time period that precedes the date on which an entity is required to register as a Swap Dealer.[1650]

As indicated above, we estimate that up to 35 of 55 entities seeking to register as SBS Entities may be registered with the CFTC as Swap Entities. Additionally, based on an analysis of 2014 TIW data on accounts likely to trigger SBS Dealer registration requirements, we have identified 18 entities belonging to a corporate group with at least one MSRB registered broker-dealer or bank-dealer.[1651] Finally, as discussed in section V, the Commission continues to estimate that the overwhelming majority of independent representatives of special entities subject to these final rules are likely already registered

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1650 See CFTC 77 FR at 9827. See also: CFTC No-Action Letter No. 12-33 Amended, available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/12-33.pdf, last accessed 8/27/2015.

1651 See "Broker-Dealers and Bank Dealers Registered with the MSRB", available at http://www.msrb.org/BDRegistrants.aspx , last accessed 2/8/2016.

as municipal advisors.[1652] As a result of the pay to play rules currently in effect, some SBS Entities and third-party independent advisers of special entities may have restructured their business practices in various markets to comply with certain restrictions imposed by pay to play rules on investment advisers, municipal advisors, and SBS Entities discussed above.

C. Costs and Benefits of Business Conduct Rules

1. Verification of Status and Know Your Counterparty Rules

Rule 15Fh-3(a)(1) requires an SBS Entity to verify that a counterparty meets the standards for an eligible contract participant before entering into a security-based swap with the counterparty, except for transactions executed on a registered national securities exchange. Rule 15Fh-3(a)(2) requires SBS Entities to verify whether a known counterparty is a special entity before entering into a security-based swap with that counterparty, except for transactions executed on a registered or exempt SEF or registered national securities exchange, where the SBS Entity does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit compliance with obligations of the rule. Rule 15Fh-3(a)(3) requires SBS Entities to verify whether a counterparty is eligible to elect not to be a special entity under Rule

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[1652] As of January 1, 2016 there were 665 municipal advisors registered with the Commission (http://www.sec.gov/help/foia-docs-muniadvisorshtm.html). Of those, 381 indicated that they expect to provide advice concerning the use of municipal derivatives or advice or recommendations concerning the selection of other municipal advisors or underwriters with respect to municipal financial products or the issuance of municipal securities. We expect that many of these municipal advisors will also act as independent representatives for other special entities. As discussed in Section V, the Commission estimates that approximately 385 municipal advisors will act as independent representatives to special entities with respect to security-based swaps.

15Fh-2(d)(4) and, if so, notify such counterparty of its right to make such an election.[1653] Finally, Rule 15Fh-3(e) requires that SBS Dealers establish, maintain and enforce written policies and procedures reasonably designed to obtain and retain records of the essential facts concerning each known counterparty necessary for conducting business with such counterparties. The scope of such essential facts includes facts required to comply with applicable laws, regulations and rules; facts required to implement the SBS Dealer's credit and operational risk management policies; and information regarding the authority of persons acting for such counterparties.[1654]

We recognize that many SBS Entities, in the course of business, already may be conducting due diligence and fact gathering concerning their security-based swap counterparties, which may reduce the economic effects of this rule.

The scope of the "know your counterparty" rule reflects differences in the roles of entities likely to register as SBS Dealers and entities that may register as Major SBS Participants. The Commission believes that entities that will register as SBS Dealers will intermediate a large volume of security-based swap transactions as both principal risk holders and agents transacting on behalf of principal risk holders, such as special entities. As discussed in the economic baseline, we understand that entities currently operating as dealers in security-based swap markets play a central intermediation role, transacting with hundreds and thousands of non-dealer counterparties and accounting for large activity volumes. At the same time, the Commission expects that Major SBS Participants will hold large positions in security-based swaps, but have low volumes of security-based

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1653 See Section II.H supra.

1654 The ability of SBS Entities to rely on representations to comply with these and other business conduct rules is discussed in detail in the section VI.C.4 below.

swap activity. Hence, we expect Major SBS Participants may not play the central intermediation role fulfilled by SBS Dealers.

These rules limit the scope of application of the "know your counterparty" requirement to SBS Dealers, and exclude Major SBS Participants. As a result, entities that may register as Major SBS Participants will not bear the costs of compliance with this rule. At the same time, SBS Dealers will be required to comply and bear related compliance costs. We note that this approach is substantially similar to the CFTC's final external business conduct rules, which limit the scope of "know your counterparty" requirements to Swap Dealers. This results in a consistent treatment of entities that may trigger both Major Swap Participant and Major SBS Participant registration requirements, and will enable Major Swap Participants to enter into security-based swap positions without bearing additional compliance costs to comply with our "know your counterparty" requirement.

To the extent that SBS Dealers do not already collect and retain essential facts about their counterparties as a part of their normal course of business, this requirement will increase the cost to SBS Dealers of entering into security-based swaps. Specifically, SBS dealers will incur costs of complying with the verification requirements and costs of establishing, maintaining, and enforcing policies and procedures reasonably designed to obtain and retain essential facts about each known counterparty that are necessary for conducting business with such counterparty. We note that the ability to rely on counterparty representations to fulfill the SBS Dealer diligence requirement partly lowers compliance burdens, as reflected in our estimates. Further, to the extent that the majority of SBS Entities have already cross-registered with the CFTC as Swap Entities and have

become subject to substantially similar verification and "know your counterparty" requirements, and to the extent the majority of their counterparties transact across swap and security-based swap markets and have already benefited from existing CFTC rules, the economic effects of these final rules may be partly mitigated.

Direct costs of compliance with verification of status requirements related to adherence to standardized protocols by SBS Entities that are not dually registered as Swap Entities are estimated at, approximately, $17,600.[1655] As discussed in Section V, these estimates include costs related to verification of counterparty's eligibility to elect not to be a special entity and notification of counterparties of their right to make such an election. In addition, SBS Dealers will also be required to comply with "know your counterparty" obligations, which will require a review of existing policies and procedures and related documentation, involving an estimated initial cost of $95,000 for all SBS Dealers.[1656] Further, direct ongoing costs of "know your counterparty" obligations are estimated at approximately $4,370,000 per year for all SBS Dealers. [1657]

Increases in SBS Entity costs due to these obligations may be reflected in the terms offered to counterparties, and increases in counterparty costs may affect their willingness to transact in security-based swaps. Further, counterparties of SBS Entities that are not also participating in swap markets and relying on the above protocols may incur costs associated with the verification of status requirement and related adherence

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1655 Initial outside counsel cost: $500 * (20 non-CFTC registered SBS Entities) = $10,000. Initial adherence letter burden: (In-house attorney at $380 per hour) x 20 hours = $7,600

1656 Initial cost: (In-house attorney at $380 per hour) x 250 hours = $95,000.

1657 (In-house attorney at $380 per hour) x 11,500 hours = $4,370,000.

letters, estimated at approximately $3,051,840.[1658] As estimated in Section V, counterparties or their agents will also be required to collect and provide essential facts to the SBS Dealer to comply with the "know your counterparty" obligations for an initial total cost estimate of approximately $41,420,000.[1659]

We note that the eligible contract participant status verification requirement does not apply to transactions executed on a registered national securities exchange. In addition, the special entity status verification requirement does not apply to transactions where the SBS Entity does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit compliance. This limits the scope of the transactions covered by final rules, therefore potentially reducing the expected benefits. However, since anonymous transactions will not be subject to these requirements, the rule imposes lower costs, delays and implementation challenges with respect to anonymous trades. This approach to anonymous transactions executed on registered exchanges or SEFs may incentivize SBS Entities to trade through these venues, to avoid imposition of these obligations under final business conduct rules. The compliance costs imposed on SBS Entities by these and other business conduct requirements (excluding anonymous transactions executed on a registered exchange or SEF) may lead to a decrease in the volume of OTC bilateral security-based swap trades, and an increase in the volume of transactions executed on exchanges or SEFs. This may facilitate liquidity, price discovery and risk mitigation in these transparent venues, which

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1658 Initial costs of disclosure of essential facts: $500 x (3,468 counterparties) = $1,734,000. Initial costs of adherence letters: (In-house attorney at $380 per hour) x 3,468 counterparties= $1,317,840. Total initial costs: $1,734,000 + $1,317,840 = $3,051,840

1659 Initial cost: (In-house attorney at $380 per hour) x 109,000 hours = $41,420,000

may attract greater market participation. The overall effects will depend on the value of disclosure and suitability requirements, customization and bilateral relationships in OTC transactions, compared with the standardization, liquidity and execution quality of contracts in SEFs and exchanges, among others.

As an alternative to the approach taken in the final rules, the Commission has considered imposing specific requirements as to the form and manner of documentation. Specific documentation requirements could result in greater information gathering and documentation by SBS Entities fulfilling their status verification and "know your counterparty" obligations, which may further strengthen counterparty protections and reduce evasion. However, we recognize commenter concerns regarding costs and loss of flexibility from imposing specific documentation requirements, and the importance of private contractual negotiation, as well as the need to impose effective verification and documentation requirements to facilitate enforcement.[1660] We therefore declined to adopt this approach.

The Commission is adopting a "know your counterparty" requirement based on a policies and procedures approach. However, the final rules explicitly delineate certain items that the Commission believes are essential facts concerning the counterparty that are necessary for conducting business with such counterparty. The CFTC has adopted a substantially similar requirement for swap dealers to implement policies and procedures reasonably designed to obtain and retain a record of the essential facts about each known counterparty that are necessary for conducting business with such counterparty. As noted earlier, in light of extensive cross-market participation between swap and security-based

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[1660] See FIA/ISDA/SIFMA, supra note 5; CFA, supra note 5.

swap markets, and expected cross-registration of SBS Entities already complying with CFTC's business conduct rules, harmonization with the CFTC regime may facilitate continued integration between these markets and may potentially reduce duplicative compliance costs for some dual registrants.

2. Disclosures and Communications

The Commission is adopting rules concerning SBS Entity disclosures of material risks, characteristics, incentives, conflicts of interest and daily mark of security-based swaps to their counterparties. The final rules also require SBS Entities to make a written record of the non-written disclosures and provide a written version of these disclosures to counterparties no later than the delivery of the trade acknowledgement for a particular transaction. We note that the scope of the final disclosure requirements is limited to counterparties that are not themselves SBS or Swap Entities, the economic effects of which are discussed below.

Broadly, these disclosure rules may mitigate information asymmetries between more informed SBS Entities and less informed counterparties, and may allow them to make more informed decisions about capital allocation and counterparty selection. At the same time, SBS Entities profit from information rents[1661] and, to the extent that

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[1661] Rents refer to profits that SBS Entities earn by trading with counterparties who are less informed. In a market with competitive access to information, there is no informational premium; SBS Entities only earn a liquidity premium. The difference between the competitive liquidity premium and the actual profits that SBS Entities earn is the economic rent. See Cross-Border Adopting Release, 79 FR 47283.

As the Commission articulated in other releases, transparency stemming from the SDR Rules and Regulation SBSR should reduce the informational advantage of SBS dealers and promote competition among SBS dealers and other market

disclosures will inform their counterparties, SBS Entities may forgo profits on security-based swaps with counterparties as a result of these requirements. In addition, SBS Entities will incur direct compliance costs. As discussed in Section V and consistent with our analysis in the Proposing Release, compliance with disclosure rules will involve an initial cost burden of which has been estimated at approximately $25,080,000, with the ongoing burden estimated at $2,508,000 for all SBS Entities.[1662] Similarly, the Commission estimates that information technology infrastructure required to comply with final disclosure rules will require will cost approximately $124,520,000 initially, and an additional $62,260,000 per year for all SBS Entities.[1663] In addition, the Commission estimates that SBS Entities will incur costs of evaluating whether more particularized disclosures are necessary for each transaction and of developing the additional disclosures for an ongoing aggregate estimated cost of $121,124,000.[1664] These and other costs less amenable to quantification and discussed below may be passed on to counterparties.

These rules may enhance transparency and protect counterparties, but may also adversely affect the willingness of SBS Entities to intermediate OTC security-based swaps with non-SBS or Swap Entity counterparties, and the costs of entering OTC

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participants. See SDR Registration Release 80 FR at 14528, supra note 1202; Regulation SBSR Adopting Release, supra note 1602.

1662 Initial cost: (In-house attorney at $380 per hour) x 66,000 hours = $25,080,000. Ongoing cost: (In-house attorney at $380 per hour) x 6,600 hours = $2,508,000.

1663 Initial cost: (Compliance manager at $283 per hour) x 440,000 hours = $124,520,000. Ongoing cost: (Compliance manager at $283 per hour) x 220,000 hours = $62,260,000.

1664 Ongoing cost: (Compliance manager at $283 per hour) x 428,000 hours = $121,124,000

security-based swaps for non-SBS or Swap Entity counterparties may increase. This fundamental tradeoff is discussed in more detail in the sections below with respect to individual disclosure requirements, their scope and implementation. The overall economic effects of the final disclosure requirements will depend on the severity of informational asymmetries and conflicts of interest in security-based swap markets, the ability of some counterparties of SBS Entities to obtain similar information independently without the required disclosures and the costs of doing so,[1665] and the information content of the required disclosures, and the extent to which market participants have already learned from similar disclosures pertaining to swap transactions.

We note that the SBS Entities will not be required to comply with pre-transaction disclosure requirements if the identity of the counterparty is not known to the SBS Entity at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with these obligations.

a. Risks, Characteristics, and Conflicts of Interest

Rule 15Fh-3(b) requires SBS Entities to make disclosures concerning a security based swap's material risks and characteristics, and the SBS Entity's material incentives or conflicts of interest before entering into a security-based swap. In addition to implementing the statutory requirements, the rule also requires SBS Entities to make a written record of the non-written disclosures and provide a written version of these

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[1665] See Table 2 of the economic baseline, which shows the overwhelming majority of most groups of non-dealer market participants are represented by investment advisers in security-based swap transactions. See also, e.g., MFA, supra note 5.

disclosures to counterparties in a timely manner, but no later than the delivery of the trade acknowledgement for a particular transaction.

In evaluating the economic effects of this rule, we note that security-based swaps are complex products, and security-based swap markets are more opaque than markets for regular equity or fixed income products. Security-based swap markets are characterized by a high degree of informational asymmetry among various groups of counterparties. As described in the economic baseline, dealers intermediate large volumes of security-based swaps, observe quote solicitations and order flow. In addition, SBS Dealers may serve in a variety of capacities such as placement agents, underwriters, structurers, securitizers, and lenders in relation to security-based swaps and the securities underlying them. Further, as outlined above, SBS Dealers generally have business incentives that may be competing with those of their counterparties as a result of taking on the opposite side of the transactions, and may have specific conflicts of interest due to their advisory, market making, trader and other roles. As discussed in Section VI.A, Major SBS Participants may also be better informed about the risks and valuations of security-based swaps due to their large positions in security-based swaps, compared with their non-SBS Entity counterparties.

At the same time, counterparties that are not SBS or Swap Entities do not observe quote solicitations or order flow, and are less likely to arrange or structure security-based swaps and their underlying securities. Such counterparties may also be generally less informed about the nature and risks of security-based swaps due to their low volume of activity, as indicated by the low transaction share of non-dealers in Table 1 of the economic baseline. Many non-dealer counterparties transact in security-based swaps

through investment advisers; however approximately 7% transact in security-based swaps directly. If the required disclosures are informative to non-SBS Entities, these final rules may help less informed market participants make more informed counterparty and capital allocation choices. The records requirement may facilitate the implementation of the disclosure requirement, enabling counterparties to reference the non-written disclosures made prior to entering into the swap during the life of the security-based swap.

As we have recognized,[1666] informational asymmetry can negatively affect market participation and decrease the amount of trading—a problem commonly known as adverse selection.[1667] When information about security-based swap risks, liquidity, pricing and counterparty incentives is scarce, market participants may be less willing to enter into transactions and the overall level of trading may fall. To the extent that adverse selection costs are currently present in security-based swap markets, if market participants become better informed as a result of these final rules, they may increase their activity in security-based swaps, which may facilitate greater informational efficiency and liquidity in security-based swap markets. Disclosures may inform counterparties of SBS Entities about security-based swap markets, and counterparties may learn from repeatedly accessing these markets. Hence, most of the benefits are expected to be incurred by existing participants when the first disclosures are made, and by new market participants when they first enter the market. However, to the extent that disclosures will contain transaction-specific information concerning risks, incentives,

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1666 See, e.g., Registration Adopting Release 80 FR at 49004, supra note 989

1667 See George A. Akerlof, *The Market For "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488 (1970).

pricing and clearing of individual security-based swaps, the informational benefits described above may persist.

At the same time, disclosures required under these proposed rules will involve costs to SBS Entities and their counterparties. As discussed in Section V, SBS Entities will bear direct compliance burdens related to the disclosures, which are reflected in our compliance cost estimates above. In addition, since SBS Entities are more informed about security-based swaps, they are able to extract information rents in the form of higher markups and fees charged to non-dealer counterparties. If SBS Entity disclosures better inform counterparties concerning characteristics and risks of security-based swaps, these rules may reduce the informational advantage of SBS Entities relative to their counterparties and decrease profitability of transactions with non-SBS Entity counterparties, which may reduce incentives for dealers to provide liquidity to these counterparties.[1668]

We recognize that the above costs may be passed on to counterparties through more adverse price and non-price terms of security-based swaps. To the extent that SBS Entities may be unable to recover these costs, they may become less likely to intermediate transactions with non-SBS or Swap Entity counterparties and decrease participation in U.S. security-based swap markets. Further, since final business conduct

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[1668] For instance, Grossman and Stiglitz (1980) showed that because information is costly, prices cannot perfectly reflect the information which is available, since if it did, those who spent resources to obtain it would receive no compensation. In other words, informational efficiency reduces incentives of economic agents to expend resources to acquire information, and there is an equilibrium amount of "disequilibrium". See Sanford J. Grossman and Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 American Economic Review 393-408 (1980).

rules require these disclosures to be made prior to entering into the security-based swap, the disclosure requirements may involve some delays in execution and may affect liquidity in security-based swaps, to the extent that these disclosures are not already being made in master agreements or post trade acknowledgements. We have considered how the timing, manner and content of disclosures may affect these competing considerations. First, we recognize that the ability to rely on master agreements, standardized disclosures and ex post trade acknowledgements of oral disclosures may significantly reduce ongoing transaction specific costs and potential execution delays, as recognized by a commenter,[1669] but may reduce the specificity and information content of disclosures. As the Commission discussed in the Proposing Release,[1670] security-based swaps are executed under master agreements and SBS Entities may elect to make required disclosures in a master agreement or accompanying standardized document. However, as stated in the Proposing Release and discussed in Section II, supra, standardized disclosures will not be sufficient in all circumstances and certain provisions may need to be tailored to the particular transaction, most notably pricing and other transaction-specific commercial terms.

We have considered commenter concerns that oral disclosures may not satisfy the goal of pre-trade transparency, may make enforcement more difficult, and may allow SBS Entities to obscure conflicts of interest and misrepresent risks until after trade confirmation.[1671] However, we are sensitive to the fact that alternative requirements to

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1669 See FIA/ISDA/SIFMA, supra note 5.

1670 See Proposing Release, 76 FR at 42406, supra note 3.

1671 See CFA, supra note 5.

provide extensive written disclosures of risks, characteristics, incentives and conflicts of interest before an SBS Entity enters into a transaction with a counterparty may increase transaction costs or impose execution delays, which may be particularly significant in periods of high market volatility. We have received comments that a requirement to provide these disclosures "at a reasonably sufficient time" prior to entering the security-based swap transaction, in writing may better inform unsophisticated counterparties,[1672] however it may further raise the risks discussed above. These could result in potentially significant execution delays, decreases in liquidity and SBS Entity willingness to intermediate transactions with non-SBS or Swap Entity counterparties. We also note that, as proposed, under the final rules, standardized disclosure will not be sufficient in all circumstances: some forms of disclosure may be highly standardized, but certain provisions will need to be tailored to reflect material characteristics of individual transactions, most notably pricing and other transaction-specific commercial terms. The CFTC's approach to manner and form of disclosures is substantially similar to the proposed requirements and to the rule being adopted. In the Proposing Release, the Commission interpreted the statutory requirement to disclose material risks and characteristics of the security-based swap itself, and not of the underlying reference security or index.[1673] As an alternative, the Commission could include underliers in the scope of required disclosures. Compared to the approach being adopted, the alternative may help better inform less sophisticated investors and enable them to make better tailored investment decisions. However, it may increase transactional costs and

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[1672] See Better Markets (August 2011), supra note 5 and CFA, supra note 5.

[1673] See Proposing Release, 76 FR at 42407, supra note 3.

execution delays, which are particularly costly during times of high market volatility. Further, information about many underliers, such as corporate, municipal and sovereign bonds, is more likely to be publicly available.

We have received mixed comments on the relative balance of these competing considerations with respect to underlier disclosures.[1674] Under the CFTC's approach, disclosures regarding underlying assets are not generally required, but to the extent that payments or cash-flows of the swap are materially affected by the performance of an underlying asset for which publicly available information is not available, the Swap Entity is required to provide disclosure about the material risks and characteristics of the underlying asset to enable the counterparty to assess the material risks of the swap. As described in Section II, our final rules require disclosure regarding the referenced security, index, asset or issuer if it would be considered material to investors in evaluating the security-based swap, including any related payments.

Finally, we have considered the alternatives of adopting more prescriptive requirements of characteristics to be disclosed, an explicit risk taxonomy, requirements concerning volatility and liquidity metrics, and scenario analysis regarding political, economic events and underlying market factors. These approaches also present a tradeoff between informing investors and protecting counterparties, and costs and willingness of SBS Entities to intermediate trades with non-SBS or Swap Entity counterparties, similar to the effects described above.

[1674] See, e.g., Better Markets (2011) Letter; SIFMA (2011) Letter; FIA/ISDA/SIFMA supra note 5; Levin, supra note 5; Markit, supra note 5; Barnard, supra note 5; CFA, supra note 5. Also see Section II.G.2 supra.

For instance, disclosure of a scenario analysis may inform counterparties, but may be particularly costly since such analysis may depend on the specific terms of the agreement. To the extent that the provision of scenario analysis will impose costs on SBS Entities, a requirement to include scenario analysis as part of mandated disclosures may result in bundling research and advice, with SBS intermediation functions for all affected transactions. This would increase costs to SBS Entities, and these costs are likely to be passed on to counterparties. Further, one commenter suggested that the requirement to produce and disclose scenario analysis for each transaction may delay execution and expose counterparties to market risk in times of market volatility.[1675]

As an alternative, the CFTC's approach allows counterparties to opt in to receive the scenario analysis for swaps that are not available for trading on a SEF, and requires Swap Dealers to disclose to counterparties their right to receive the scenario analysis. The CFTC's external business conduct rules do not prescribe whether and how swap dealers may be able to charge for such analysis and we do not have data regarding whether any counterparties are taking advantage of the rule provision. We understand that counterparties already privately negotiate terms of over-the-counter derivatives with SBS Dealers, which may also serve in advisory and other capacities. As discussed in the economic baseline, non-dealer market participants are typically institutional investors, the overwhelming majority of which rely on investment advisers in their security-based swap activities. It is unclear that a requirement to disclose the right to receive a scenario analysis would affect the demand for such analyses or inform counterparties.

[1675] See SIFMA (August 2011), supra note 5.

The Commission has also considered an alternative of adopting prescriptive risk taxonomies, and requiring disclosure of volatility and liquidity metrics. While these requirements may reveal additional information to counterparties, they may be less informative for customized over-the counter security-based swaps, may fail to capture risks of new products, and would increase costs. To the extent that these requirements would increase SBS Entity costs of transacting with non-SBS or Swap Entity counterparties, these costs would also adversely affect terms of security-based swaps for non-SBS or Swap Entity counterparties. Rule 15Fh-3(b)(2) also requires SBS Entities to disclose any material incentives or conflicts of interest that an SBS Entity may have in connection with the security swap, including any compensation or other incentives from any source other than the counterparty. As articulated in Section II, this rule will not require SBS Entities to report all profits or expected returns from the swap or related hedging or trading activities, but will require reporting of incentives, such as revenue sharing arrangements, from any source other than the counterparty in connection with the swap. To the extent that disclosure informs counterparties regarding SBS Entity conflicts of interest, counterparties of SBS Entities may become better able to make informed decisions about security-based swaps and the SBS Entities they transact with. When SBS Entity conflicts of interest are severe, disclosure of such conflicts may lead counterparties to renegotiate the terms of a transaction or select another counterparty with fewer conflicts of interest, contributing to more efficient capital allocation by non-dealer counterparties. Importantly, this requirement does not prohibit material conflicts of interest. Instead, the rule focuses on disclosure of material incentives and conflicts of interest, which may help counterparties better evaluate the terms and risks of transacting

with an SBS Entity. The severity of these conflicts of interest in security-based swaps, the awareness of non-SBS or Swap Entity counterparties about these conflicts, the similarity between disclosures of conflicts already made by SBS Entities cross-registered as Swap Entities under CFTC rules with disclosures that will be made under these final rules, and the informativeness of the newly required disclosures will influence the magnitude of the benefits described above.

We recognize that final external business conduct rules for Swap Entities are already in place and include a similar set of conflict of interest disclosure rules. Swap Entities are already disclosing incentives and conflicts of interest in swap transactions, which enters into our economic baseline and is reflected in current market activity. Non-SBS or Swap Entity counterparties that are transacting with the same dealers in both swap and security-based swap markets have benefited from such disclosures in swap markets, and may have already become familiar with standardized disclosures by Swap Dealer counterparties. To the extent that disclosures by the same dealers related to, for instance, index CDS and single name CDS may be similar, such counterparties may enjoy fewer benefits of these final rules. However, we note that the rules being adopted require disclosures specific to security-based swap transactions, and certain disclosures will need to be tailored to a particular security-based swap.

In addition to direct costs of compliance born by SBS Entities, to the extent that disclosures will provide new and relevant information about SBS Entity conflicts of interest, SBS Entities with significant conflicts of interest may lose business to SBS Entities that do not have such conflicts. While this requirement may impose costs on those SBS Entities with the most acute conflicts, such disclosures may benefit less

conflicted SBS Entities, enhance protections of counterparties, and improve the ability of market participants to make informed counterparty decisions.

We have considered the costs and benefits of an alternative requiring a disclosure of the difference in compensation between selling a security-based swap versus another product with similar economic terms, or expected profit of the SBS Entity from the transaction, as suggested by some commenters.[1676] We do not believe that disclosure of SBS Entity profits to counterparties would protect counterparties or improve their ability to make suitable investment decisions, relative to the approach being adopted, and are not adopting this alternative. SBS Entities compete for business on price, execution quality, underlier and counterparty risks, among others. We understand that counterparties need information about price, non-price terms and risks of the security-based swap and conflicts of interest of the SBS Entity to be able to assess the relative merits of a particular transaction. The final business conduct rules being adopted will require SBS Entities to disclose to their non SBS Entity counterparties material characteristics and risks of the transaction, as well as any compensation or incentives from any source other than the counterparty in connection with the security-based swap. Rules 15Fh-3(c) and 15Fh-3(d), the economic effects of which are discussed below, will also require disclosure of the daily mark and clearing rights. We also note that SDR Rules and Regulation SBSR adopted by the Commission will introduce post-trade transparency to security-based markets, and counterparties will have access to more extensive and more accurate information upon which to make trading and valuation determinations when compliance with these rules is required.

[1676] See CFA, supra note 5; Levin, supra note 5.

SBS Entities are for-profit entities, buying security-based swaps from counterparties seeking to sell them; and selling swaps to counterparties seeking to purchase them. When SBS Entities carry balance sheet risk, they profit from directional price moves that result in losses for their counterparties and so, they may have an incentive to offload security-based swaps in their inventory on less informed non-dealer counterparties, even where such security-based swaps are unsuitable. When SBS Entities hedge their inventory risk and do not carry balance sheet exposure, they benefit from charging higher costs and fees to their counterparties. SBS Entity business incentives may, therefore, be generally competing with the interests or positions of their counterparties. However, SBS Entities have reputational incentives and benefit from intermediating a greater volume of trade which, all else given, mitigates this conflict. Further, it is unclear that market participants are generally unaware of these competing incentives.

SBS Entities act as principal risk holders and transacting agents effecting security-based swaps on behalf of their customers. An SBS Entity's expected return on a security-based swap depends on, among others, price terms of the swap, cost of funds, shorting constraints, balance sheet exposures, costs of underlying elements of the security-based swap, and costs of structuring the security-based swap. It is unclear that disclosure of expected profits of an SBS Entity has any bearing on a counterparty's expected cost of the transaction, quality of execution or assessment of the risks of a security-based swap given the counterparty's investment objectives, horizons, hedging

needs, financial condition etc.[1677] As a practical consideration, the SBS Entity's expected profit would depend on potentially proprietary data and valuation models, and numerous assumptions about future market factors. At the same time, such a requirement would impose direct costs of producing disclosures and potential reputational costs on SBS Entities; if the costs become significant, some SBS Entities may reduce security-based swap market activity with non-SBS or Swap Entity counterparties. We note that the rules being adopted not only require disclosure of material characteristics, risks, conflicts of interest or incentives, daily mark and clearing rights, but also include fair and balanced communications, antifraud, supervision, compliance, and conduct requirements.

b. Daily Mark

Rule 15Fh-3(c) requires SBS Entities to disclose the daily mark to counterparties other than SBS or Swap Entities upon request. For cleared security-based swaps, the rules require an SBS Entity to disclose, upon request of the counterparty, the daily mark that the SBS Entity receives from the appropriate clearing agency. For uncleared swaps, Rule 15Fh-3(c) implements the statutory provision and requires the SBS Entity make this disclosure on a daily basis 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 method for computing the daily mark is not provided in the statute. For uncleared swaps, the SBS Entity would also be able to use market quotations for comparable security-based swaps and model implied valuations. The SBS Entity is also required to disclose data sources, methodologies and

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1677 For instance, one commenter asserted that the best protection for a counterparty is reviewing and selecting the best available pricing. See FIA/ISDA/SIFMA, supra note 5;

assumptions used to prepare the daily mark, and promptly disclose any material changes to the above during the term of the security-based swap.

Similar to the economic effects of disclosures concerning material risks and characteristics of security-based swaps, the overall impact of the daily mark disclosure depends on the severity of the informational asymmetries between SBS Entities and counterparties regarding market prices of security-based swaps; the amount of disclosure unsophisticated counterparties require to become better informed; the informativeness of the disclosures; and the direct and indirect costs of producing such disclosures by SBS Entities. For cleared security-based swaps, the requirement to disclose the daily mark from clearing agencies is an explicit statutory requirement, and provides a standardized and comparable reference point for counterparties.[1678] As described above, based on the current model for clearing security-based swaps, the security-based swap between the SBS Entity and counterparty is terminated upon novation by the clearing agency. The SBS Entity would no longer have any obligation to provide a daily mark to the original counterparty because a security-based swap no longer exists between them. Therefore, there would not be any ongoing burden on the SBS Entity.

The ability of SBS Entities to rely on quotes, model imputed prices or prices of comparable security-based swaps to calculate the daily mark for uncleared swaps may

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[1678] We have received comment that SBS Entities may have direct or indirect affiliations or relationships with clearing agencies and market data providers, which may pose conflicts of interest. See Levin, supra note 5. Should such conflicts exist, they may be partly mitigated by other substantive business conduct requirements being adopted, such as the antifraud provision, requirement to engage in fair and balanced communications, and other statutory obligations. Further, counterparties will be able to select the venue in which security-based swaps will be cleared and will benefit from SBS Entities' disclosures of incentives and conflicts of interest under these final rules.

produce valuations that are potentially superior to stale market prices on illiquid contracts. However, we continue to recognize that SBS Entities may influence the daily mark disclosed to their less sophisticated counterparties by varying modeling assumptions, data sources and methodology which produce the daily mark, as supported by some commenters.[1679] This tradeoff is partially mitigated by the requirement to disclose data sources and a description of the methodology and assumptions used to prepare the daily mark, and promptly disclose any material changes during the term of the swap.

As we recognized in the Proposing Release,[1680] we anticipate significant variability in the models and data sources, methodology and assumptions used by different SBS Entities, 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 an indicator in the reporting of their positions may report different valuations of similar security-based swap positions. However, we continue to believe that since, as quantified in the economic baseline, non-dealer counterparties typically transact with multiple dealers, counterparties may be able to observe and analyze differences in security-based swap valuations across SBS Entities. We recognize that the daily mark may not be a reliable reference point for estimating fair values, potential net asset values or prices at which the security-based swap could be executed as suggested by

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1679 See, e.g., Levin, supra note 5; IDC, supra note 5.

1680 See Proposing Release, 76 FR at 42449, supra note 3. Also see, e.g., FIA/ISDA/SIFMA, supra note 5.

a commenter,[1681] however, we continue to believe that it may inform counterparty understanding of their financial relationship with SBS Entities.[1682]

We are sensitive to cost considerations, and recognize that costs borne by SBS Entities as a result of the final business conduct rules may be passed on to counterparties in the form of higher transaction costs. Further, if these costs are significant, SBS Entities may reduce their security-based swap activity or become less willing to intermediate swaps with certain groups of counterparties. As a result, liquidity, price discovery and market access of certain groups of counterparties may be adversely affected. As articulated in the Proposing Release, we understand that SBS Entities routinely assess end-of-day values in the course of their business as an integral component of risk management. We continue to believe that SBS Entities may already be estimating values that may be used to fulfil the daily mark disclosure requirement, and, therefore, to the extent this is the case, direct compliance costs of this requirement to costs of producing disclosures may be less than estimated above.

One commenter indicated that requiring Major SBS Participants to comply with the daily mark requirement for uncleared swaps would result in "significant, unnecessary increased costs without any meaningful benefit."[1683] We recognize that the broader scope of this requirement will impose costs on Major SBS Participants, as reflected in our compliance cost estimates. To the extent that Major SBS Participants may be better informed about the risks and valuations of security-based swaps and more sensitive to

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1681 See MFA, supra note 5.

1682 See Proposing Release, 76 FR at 42449, supra note 3.

1683 See MFA, supra note 5.

market risk due to their significant positions, disclosures of the daily mark may help their non SBS Entity counterparties make more informed counterparty and valuation determinations. We note that the rules being adopted provide all SBS Entities significant flexibility with respect to how they may estimate the daily mark for uncleared swaps. Specifically, similar to SBS Dealers, Major SBS Participants will be able to rely on market quotes for similar swaps, model based prices or some combination thereof under Rule 15Fh-3(c). The Commission continues to believe that informing counterparties' understanding of their financial relationship with SBS Entities is an important benefit of these final rules.

As discussed in Section II, supra, SBS Entities will not necessarily be able to use the same mark for collateral purposes and for meeting the disclosure requirement. We recognize commenter concern that this approach may impose additional costs of estimating and disclosing a daily mark valuation on SBS Entities with respect to transactions where both counterparties have agreed on a basis for margining uncleared swaps.[1684] As discussed above, the Commission continues to believe that the daily mark disclosure, as being adopted for the purposes of this rule, would provide a useful and meaningful reference point for counterparties holding positions in uncleared security-based swaps.

Currently, entities that are likely to trigger SBS Entity registration requirements due to their volume of dealing activity are not required to disclose daily marks of security-based swaps, or data sources, assumptions and methodologies used to calculate them. While this requirement is currently effective in swap markets and some SBS

[1684] See FIA/ISDA/SIFMA, supra note 5.

Entities may be making such security-based swap specific disclosures voluntarily, these final rules impose mandatory disclosure requirements on all SBS Entities in their security-based swap transactions with counterparties that are not themselves SBS Entities or Swap Entities. The requirement to disclose data sources, assumptions and methodology used to calculate the value of security-based swaps may reduce the informational advantage SBS Entities enjoy as a result of developing superior valuation models or information, as supported by public comments.[1685] However, these costs are partly mitigated by the ability to rely on standardized disclosures and a description of the models, as opposed to disclosures of the models themselves.

c. Clearing Rights

Finally, Rule 15Fh-3(d) requires SBS Entities to make disclosures regarding clearing rights to counterparties that are not SBS Entities or Swap Entities before entering into the security-based swap. For security-based swaps not subject to mandatory clearing, the SBS Entity would be required to determine whether the security-based swap is accepted for clearing by one or more clearing agencies, to disclose the names of clearing agencies that accept the security-based swap for clearing, and to notify the counterparty of their right to elect clearing and the agency used to clear the transaction. For security-based swaps subject to mandatory clearing, the final rules require SBS Entities to disclose clearing agency names to the counterparty, and to notify the counterparty of their right to select the clearing agency subject to Section 3C(g)(5) of the Act. The rule also requires SBS Entities to make a written record of the non-written

[1685] See, e.g., MFA, supra note 5; IDC, supra note 5.

disclosures and provide counterparties with a written version of these disclosures no later than the delivery of the trade acknowledgement of the transaction.

The required disclosure of clearing rights may increase how informed a counterparty is concerning the availability of clearing in general, the ability to require clearing of security-based swaps, as well as the names of clearing agencies that may accept a given security-based swap for clearing. The reliance on standardized disclosures may lead to more general and less transaction specific information being communicated, reflecting information that has already been absorbed by market participants and potentially reducing these benefits. To the extent that the rule results in greater transparency concerning clearing rights, the volume of cleared security-based swaps may increase.

We note that clearing is currently voluntary and available for CDS only. [1686] Disclosure of the clearing agencies that accept a security-based swap for clearing may inform counterparties of the right to clear and of various clearing agencies that are able to clear a given security-based swap, particularly clearing agencies that have just started accepting a given security-based swap or group of security-based swaps for clearing. This may enhance potential competition among clearing agencies in the future, which may lower clearing costs or improve quality of clearing services. The above effect may

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[1686] Mandatory clearing is not currently in effect and we currently do not have sufficient information to estimate the number and volume of security-based swap transactions executed across different trading venues and using these various execution practices. However, the Commission staff has performed an analysis of voluntary clearing activity in single name CDS markets, which generally informs our analysis. See SEC Division of Economic and Risk Analysis, Single-Name Corporate Credit Default Swaps: Background Data Analysis on Voluntary Clearing Activity, 15 (Apr. 2015), available at http://www.sec.gov/dera/staff-papers/white-papers/voluntary-clearing-activity.pdf.

be more significant if more clearing agencies register to clear security-based swaps and clearing becomes available for security-based swaps other than CDS, which are currently being cleared voluntarily.

Currently, SBS Entities are not yet required to register and are not subject to substantive Title VII requirements, including business conduct rules. Therefore, SBS Entities currently are not required to produce disclosures concerning clearing rights and a list of clearing agencies accepting a security-based swap for clearing. Entities that are currently registered with the CFTC as Swap Entities are required to make clearing rights disclosures for swap transactions. Under these final rules, all SBS Entities will bear costs of producing the clearing rights disclosures pertaining to security-based swap transactions, and communicating them to their counterparties other than SBS Entities and Swap Entities, as estimated in Sections V and VI.C above. However, we recognize that these costs may be lower for dually registered SBS Entities that may have already adjusted their systems and practices to comply with parallel CFTC rules. We also recognize that if, as a result of the disclosure, some counterparties begin choosing to clear as well as choosing the agency used to clear the transaction, SBS Entities may lose potentially beneficial flexibility related to clearing, which may affect the price of security-based swaps. In addition, if clearing rights disclosures lead to a greater volume of transactions cleared through registered clearing agencies, increases in clearing costs borne by SBS Entities may be passed on to counterparties.

3. Suitability

SBS Dealers intermediate large volumes of security-based swaps, buying products from counterparties seeking to sell them; and selling swaps to counterparties seeking to

purchase them. When SBS Dealer exposure is not hedged by offsetting transactions with other dealers, SBS Dealers act as principal risk holders, benefiting from directional price moves that result in losses for their counterparties, and vice versa. SBS Dealers carrying inventory may have an incentive to recommend security-based swaps from their inventory that may be unsuitable to their counterparties, but help to manage dealer inventory risk. When SBS Dealers hedge the underlying risk of a transaction, dealer profits stem from commissions and fees charged to their counterparties in relation to the security-based swap. As a result, SBS Dealer incentives may be generally inconsistent with, or may be contrary to the economic interests of their counterparties.

As discussed in earlier sections, SBS Dealers are more informed than their non-dealer counterparties as they can directly observe pre-trade requests for quotes and order flow. Where SBS Dealers have previously acted in other capacities, such as in the capacity of an underwriter, arranger or structurer of a security-based swap, they may have superior information about the quality and risk of a specific security-based swap and its underlying assets. As a result, SBS Dealers may have superior information about the inherent value and risk of security-based swaps, including information concerning whether a given security-based swap is unsuitable for a particular non-dealer counterparty given the counterparty's horizon and ability to absorb losses, among other things.

When SBS Dealers advise their counterparties regarding security-based swaps, the above conflicts of interest may result in recommendations of security-based swaps that may be unsuitable for a given counterparty. For instance, more complex security-based swaps are more opaque and difficult to price for less informed counterparties; they

may also be unsuitable for a greater number of non-dealer counterparties.[1687] At the same time, such transactions may be profitable for the dealer. To the extent that SBS Dealers may be recommending unsuitable security-based swaps, and to the extent counterparties may be relying on such advice and are unable to observe and decouple bias from the information component of the recommendation, counterparties may be entering into security-based transactions inconsistent with their investment objectives and risk tolerance. The central role and high market share of a small number of SBS Dealers described in the economic baseline may reduce the effectiveness of reputational considerations in mitigating these effects.

Under Rule 15Fh-3(f)(1), SBS Dealers recommending security-based swaps or trading strategies involving a security-based swap to counterparties other than an SBS Entity or a Swap Entity are required to (i) undertake reasonable diligence to understand potential risks and rewards associated with the recommendation; and, (ii) have a reasonable basis to believe that the recommended swap or strategy is suitable for the counterparty, taking into account, among other things, the counterparty's investment profile, trading objectives and ability to absorb potential losses. Rule 15Fh-3(f)(2) includes an alternative for institutional counterparties (defined as a counterparty that is an eligible contract participant as defined in clauses (A)(i), (ii), (iii), (iv), (viii), (ix) or (x), or clause (B)(ii) of Section 1a(18) of the Commodity Exchange Act and the rules and regulations thereunder, or any person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million) that allows an SBS Dealer to

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[1687] The Commission recognizes that complex over-the-counter security-based swaps may benefit some market participants due to the ability to tailor economic terms to counterparties' hedging needs or market views.

satisfy its customer-specific suitability obligations in Rule 15Fh-3(f)(1)(ii) if (i) the SBS Dealer reasonably determines that the counterparty or agent with delegated authority is capable of independently evaluating investment risks with respect to a given security-based swap or strategy; (ii) the counterparty or agent represents in writing that they are exercising independent judgment in evaluating the dealer's recommendations; and (iii) the SBS Dealer discloses that it is acting as a counterparty and not assessing suitability. Under Rule 15Fh-3(f)(3), an SBS Dealer will be deemed to have satisfied the requirements of the first prong of the institutional suitability alternative in Rule 15Fh-3(f)(2)(i) if it receives written representations that: (i) in the case of a counterparty that is not a special entity, the counterparty has complied in good faith with written policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so; and (ii) in the case of a counterparty that is a special entity, satisfy the terms of the safe harbor in Rule 15Fh-5(b).

a. <u>Costs and Benefits</u>

Rule 15Fh-3(f)(1) may benefit counterparties by requiring that SBS Dealers undertake reasonable diligence to understand the potential risk and rewards associated with recommended security-based swaps or trading strategies involving security-based swaps and that these recommendations are suitable for the counterparty given the counterparty's investment profile, trading objectives, and ability to absorb potential losses. As a result, counterparties of SBS Dealers may become more likely to allocate capital to suitable security-based swaps, potentially enhancing counterparty protections

and allocative efficiency.[1688] These benefits are expected to accrue only to the extent that some SBS Dealers otherwise may be making unsuitable recommendations, and to the extent that non-SBS or Swap Entity counterparties rely on such SBS Dealer recommendations in their capital allocation decisions. If incentive conflicts or governance failures within counterparties, or other factors unrelated to SBS Dealer recommendations, for instance, reaching for yield in low interest rate environments, contribute to potentially unsuitable security-based swap choices, the benefits of these rules may be muted. The suitability standard does not require dealers to disclose whether another suitable security-based swap or underlier has superior material characteristics. Therefore, some of the above counterparty protection and allocative efficiency benefits of the suitability standard may be less. Further, this benefit is likely to be highest for those counterparties of SBS Dealers which do not already rely on professional asset managers or independent advisers in security-based swap transactions.

The suitability requirement will impose costs on SBS Dealers. First, the rule requires SBS Dealers to undertake reasonable diligence to understand the potential risks and rewards of the security-based swaps or trading strategy involving a security-based swap they recommend. Second, the rule will involve direct costs required to make an assessment of suitability of a security-based swap or asset class for each counterparty.[1689] As estimated in Section V, we expect that SBS Dealers may seek to obtain

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1688 See, e.g., CFA, supra note 5; Levin, supra note 5.

1689 See, e.g., FIA/ISDA/SIFMA, supra note 5.

representations at an estimated cost of up to $11,393,160.[1690] Further, the Commission recognizes that suitability assessments under these final rules may give rise to potential liability and litigation costs of SBS Dealers.

In considering the economic effects of this final rule, we note that the suitability requirement does not apply to recommendations made to SBS Dealers, Major SBS Participants, Swap Dealers, or Major Swap Participants. Therefore, the rule may result in higher costs to SBS Dealers in transacting with non-SBS or Swap Entity counterparties. Additionally, costs of suitability assessments may be higher for counterparties with which an SBS Dealer has had no prior transactions.

The rule may adversely affect counterparties of SBS Dealers that are not themselves SBS Dealers, Major SBS Participants, Swap Dealers, or Major Swap Participants. In addition, SBS Dealer cost increases due to suitability assessments discussed above may be passed on to counterparties, and, if a significant percentage of the costs cannot be recovered, the willingness of SBS Dealers to make recommendations to non-dealer counterparties may decrease. Further, SBS Dealers may have superior information about the quality of security-based swaps they intermediate, but have significantly less information about their counterparty. This informational asymmetry may result in SBS Dealers not recommending security-based swaps that may be potentially suitable to the counterparty. Moreover, to the extent that customer suitability evaluations take time and require additional due diligence, the rule may result in execution delays, particularly during times of high market volatility when the value of

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1690 Initial cost: (In-house attorney at $380 per hour) x (6,271x2 hours for participants active in both swaps and SBS markets + 3,488x5 hours for participants active in SBS markets only) =380 x29,982 = $11,393,160.

risk mitigation may be higher. We note, however, that suitability requirements apply only with respect to swaps being recommended by SBS Dealers, and counterparties may continue to have access to security-based swaps intermediated without bundled SBS Dealer advice, as well as swaps executed on SEFs or registered exchanges.

The above benefits and costs of the suitability rule are likely to be limited by the scope of these final rules and the institutional suitability alternative. The suitability requirement is limited to transactions between SBS Dealers and counterparties that are not themselves SBS or Swap Entities. We believe that SBS Entities are likely to be able to independently evaluate material risks, pricing, and overall suitability of a security-based swap given, among others, their investment objectives and risk tolerance. As shown in Figure 3, the majority of trades and trade notional involved trades among dealers, which substantially reduces the scope of application of the suitability requirement. Further, as discussed below, the scope of application of the suitability rule may be reduced if SBS Dealers are able to take advantage of the institutional suitability alternative for customer-specific suitability with respect to a significant fraction of transactions.

As noted in the proposing release,[1691] many SBS Dealers may already have an obligation to make suitable recommendations in other contexts. FINRA imposes a suitability requirement on recommendations by broker-dealers and we have elsewhere estimated that up to 16 entities registering with the Commission as SBS Entities may be already operating as registered broker-dealers subject to Commission and FINRA

[1691] See Proposing Release, 76 FR at 42450, supra note 3.

oversight.[1692] As discussed in Section II, Swap Dealers registered with the CFTC are also subject to reasonable basis and customer-specific suitability requirements with respect to swap transactions under Rule 23.434, and we have elsewhere estimated that up to 35 SBS Entities may be cross-registered with the CFTC as Swap Entities. Some of these cross-registered entities may have adjusted their compliance infrastructure and recommendation practices. These considerations may mitigate both the costs and the benefits of these final rules.

b. Institutional Suitability Alternative

Rule 15Fh-3(f)(2) includes an institutional suitability alternative for customer-specific suitability assessments. SBS Dealers will be deemed to have fulfilled their customer-specific suitability obligations if they reasonably determine that the counterparty or its agent is capable of independently evaluating the investment risks; the counterparty or agent affirmatively represents in writing that they are evaluating the investment independently; and the SBS Dealer discloses that it is not undertaking to assess suitability for the counterparty. The institutional suitability alternative for customer-specific suitability requirements will not be available with respect to counterparties that are not institutional counterparties (defined as a counterparty that is an eligible contract participant as defined in clauses (A)(i), (ii), (iii), (iv), (viii), (ix) or (x), or clause (B)(ii) of Section 1a(18) of the Commodity Exchange Act and the rules and regulations thereunder, or any person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. Recommendations of any potentially unsuitable products could involve losses and lead to inefficient capital

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[1692] See Registration Adopting Release, 80 FR at 49000, supra note 989.

allocation by non-dealer counterparties when such counterparties lack the ability to independently assess suitability of security-based swap transactions they enter into. Sophisticated institutions or entities that rely on independent advisors in their decision making may be better able to independently assess the merits and suitability of a given security-based swap. Therefore, more sophisticated counterparties and counterparties that rely on independent advisers to assess disclosures and analyze the relative merits of individual swaps are less likely to benefit from the suitability rule. The institutional suitability alternative reflects these considerations.

As a result of the institutional suitability alternative, SBS Dealers will not be required to undertake customer-specific suitability evaluations for counterparties that the rule presumes are capable of independently evaluating investment risks with regard to the relevant security-based swap or trading strategy involving a security-based swap. As shown in Table 2 of the economic baseline, between November 2006 and December 2014, 99% of private funds, 100% of registered investment companies, 72% of insurance companies, 75% of non-financial firms and 98% of special entities were represented by investment advisers. Hence, non-dealer counterparties generally have third-party representation and may be able to evaluate security-based swaps independently of SBS Dealers. Many SBS Dealers may be able to rely on the institutional suitability alternative to fulfill their customer-specific suitability obligations. Therefore, a large fraction of transactions may qualify for the institutional suitability alternative, and the economic effects of the suitability requirement above may accrue to a small share of security-based swap market activity.

In addition, the institutional suitability alternative for customer-specific suitability will not be available for SBS Dealers making recommendations to counterparties that are not institutional counterparties. The $50 million asset threshold in the institutional counterparty definition narrows the scope of the alternative and increases the potential counterparty protection and allocative efficiency benefits of the final suitability rule. Our data do not allow us to estimate how many counterparties that would not meet the institutional counterparty definition are currently transacting in security-based swap markets and relying on recommendations by SBS Dealers, asset size thresholds for counterparties at which the intended information and counterparty protection benefits of these final rules become significant, or the extent to which asset size and counterparty sophistication may be correlated in security-based swap markets. We also recognize that the $50 million asset size threshold may increase costs and diverges from the suitability safe harbor adopted by the CFTC as part of business conduct standards for Swap Entities. As a result, all SBS Dealers that are dually registered with the CFTC as Swap Dealers will face a bifurcated suitability standard in swaps and security-based swaps, such as index CDS and single name CDS, with respect to counterparties that do not meet the institutional counterparty definition. In response to these final rules, dually registered SBS Dealers may choose not to rely on the institutional suitability alternative when making recommendations to counterparties that do not meet the institutional counterparty definition in both swap and security-based swap markets.

Direct burdens and costs of suitability assessments have been estimated above. The Commission also recognizes that this aspect of the institutional suitability alternative may increase system complexity, liability and other costs less amenable to quantification

that SBS Dealers will incur as a result of advising and transacting with small counterparties in security-based swaps. These costs may be passed on to counterparties of SBS Dealers, which may experience an increase in transaction costs, decreased access to SBS Dealer advice, or decreased willingness of SBS Dealers to intermediate over-the-counter security-based swaps.

However, affected counterparties may continue to retain access to anonymous SEF or exchange executed security-based swaps, which are not subject to the suitability requirements of these final rules. Further, while the asset threshold in the institutional suitability alternative diverges from the CFTC's approach to suitability for Swap Dealers, it aligns with FINRA's asset threshold for the institutional account definition. SBS Dealers cross-registered as broker-dealers are currently unable to rely on institutional suitability when recommending less complex products, such as vanilla equity or fixed income instruments, to the same group of counterparties, and may be less affected by the institutional counterparty asset threshold for the suitability alternative. We note that SBS Dealers will be able to avail themselves of the institutional suitability alternative when making recommendations to certain financial institutions, insurance companies, registered investment companies, commodity pools with at least $5 million in assets, broker-dealers, futures commission merchants, floor brokers, investment advisers and commodity trading advisors with less than $50 million in assets. As discussed above, the Commission believes that the $50 million asset threshold may enhance counterparty protection and allocative efficiency benefits of the final suitability rule relative to the alternative of not including an asset threshold as part of institutional suitability.

We note that the institutional suitability alternative is not applicable to the suitability requirement to undertake reasonable diligence to understand the potential risks and rewards associated with the recommended security-based swap or trading strategy involving a security-based swap. However, when SBS Dealers rely on the alternative, they will not be required to make customer-specific suitability assessments with respect to individual counterparties' investment profile, trading objectives and ability to absorb losses.

As clarified in Section II, the Commission believes that parties should be able to make the disclosures and representations required by Rules 15Fh-3(f)(2) and (3) on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions between the parties. As a result, SBS Dealers will not be required to assess customer-specific suitability of whole asset classes or all security-based swaps, if the counterparty makes appropriate representations and other institutional suitability requirements are met.

To the extent that security-based swaps are heterogeneous in their risk and expected return characteristics, and since the degree of counterparty sophistication and familiarity with various types of security-based swaps may vary over time, such an approach to institutional suitability may lower the benefits of the rule. However, the ability to take advantage of the institutional suitability alternative for groups of security-based swaps, asset classes or counterparties as a whole mitigates the burdens imposed on SBS Dealers,[1693] particularly when such dealers intermediate multiple homogeneous transactions with the same counterparty over a limited time period. For instance, as we

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[1693] See, e.g., Barnard, supra note 5.

have noted in the economic baseline, based on an analysis of DTCC-TIW data, an average unique dealer–nondealer pair entered into approximately 32 transactions in 2014. The ability of dealers to rely on the institutional suitability alternative for some or all of the trades with a given counterparty would be less costly, and may also limit execution delays facilitating market access to security-based swaps.

In addition to the above considerations concerning institutional suitability, we note that the final suitability requirements will not apply if an SBS Dealer does not recommend a security-based swap or trading strategy involving a security-based swap to counterparties. As estimated above, the suitability requirement imposes costs on SBS Dealers, and may decrease their willingness to recommend security-based swaps to non-SBS or Swap Entity counterparties. However, as discussed throughout the release, we believe that the overwhelming majority of market participants already have access to third party advice concerning security-based swaps.

Finally, suitability obligations will also apply to transactions with special entities, and the institutional suitability alternative described above will be available for special entity counterparties that meet the institutional counterparty definition (i.e., have total assets of at least $50 million).

4. Special Entities

The business conduct rules being adopted include a number of requirements for SBS Entities specific to their dealings with special entities governing, among other things: a) the scope of entities that will be subject to the substantive special entity standards; b) the duty to verify and inform entities when they are eligible to elect not to be considered a special entity for the purposes of these rules; c) the definition of qualified

independent representative for such purposes; d) the conduct of SBS Entities when they act as counterparties to special entities; e) the conduct of SBS Dealers when they act as advisors to special entities.

a. Scope and Verification

First, as part of verification of status requirement under Rule 15Fh-3(a)(2) , SBS Entities will be required to verify whether a counterparty is a special entity before entering into a security-based swap, unless the transaction is executed on a registered or exempt SEF or registered national securities exchange, and the SBS Entity does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the rule. Under Rule 15Fh-3(a)(3), an SBS Entity shall also verify whether a counterparty is eligible to elect not to be a special entity, and, if so, notify such counterparty of its right to make such an election. Rule 15Fh-2(e) defines the scope of special entities to include, among other things, federal and state agencies, States, cities, counties, municipalities, and other political subdivisions of a State, instrumentalities, departments or corporations of or established by a State or political subdivision of a State, employee benefit plans subject to Title I of ERISA, governmental plans as defined in Section 3(32) of ERISA, and endowments. Rule 15Fh-2(e) also provides that employee benefit plans defined in Section 3 of ERISA, that are not otherwise defined as special entities, may elect not to be treated as special entities by notifying an SBS Entity prior to entering into a security-based swap.

These final rules define the set of special entities that will be able to avail themselves of the protections in these final rules. The inclusion of entities defined in, but not subject to, ERISA into the special entity category, subject to an opt out provision,

increases the set of market participants afforded the counterparty protections under the final business conduct standards, relative to the exclusive application of these rules to entities subject to ERISA.[1694] At the same time, as discussed below, compliance with these final rules concerning special entities will entail direct and indirect costs for SBS Entities. Increased costs to SBS Entities may be passed on to special entity counterparties in the form of more adverse terms of available security-based swaps or a decreased willingness of SBS Entities to intermediate such swaps with special entities, which may reduce special entities' access to such security-based swaps.[1695] The ability of special entities defined in, but not subject to, ERISA to opt out of the special entity status may give such entities greater flexibility in structuring their relationships with SBS Entities, and allow them to trade off the benefits of counterparty protections in these final rules against potentially greater costs and lower liquidity in SBS Entity intermediated OTC security-based swaps.

We note that the opt out approach for special entities defined in, but not subject to, ERISA differs from parallel CFTC business conduct rules, which allow such entities to opt into the special entity status instead. As discussed in the economic baseline, the

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1694 See Church Alliance (August 2011), supra note 5 and Church Alliance (October 2011), supra note 5, suggesting that church plans may benefit from enhanced conduct by SBS Entities in their advisory or intermediation roles, and requesting clarification of status of church plans for purposes of regulations under Dodd Frank.

1695 As we discuss in Section VI.C.4.f, special entity rules will not apply to security-based swaps executed on registered or exempt SEFs or registered national security exchanges, where SBS Entities do not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with these final obligations. Therefore, special entities and entities defined in, but not subject to ERISA, regardless of their opt out decision, will continue to have access to anonymous SEF or exchange executed security-based swaps.

Commission expects extensive cross-registration of SBS Entities as Swap Entities, and understands most market participants transact in both swap and security-based swap markets. To the extent that SBS Entities have significant bargaining power in transactions with special entities, special entities that have selected not to opt into the special entity status in swap markets are likely to opt out of similar protections under these final rules. Therefore, it is unclear whether the ability of special entities defined in, but not subject to ERISA to opt out of special entity protections would lead to a greater number of special entities benefiting from counterparty protections in these final rules, relative to the opt in approach. We also recognize that under the final rules, if a special entity chooses to opt out of the special entity status, it would be required to provide a written notice to the SBS Entity and would bear related costs. The overall economic effects of this rule will, therefore, depend on the number of entities defined in, but not subject to, ERISA that will choose to opt out of the special entity status, the costs of producing notices, and magnitude of the transaction cost increases in OTC security-based swaps resulting from compliance with these final special entity rules.

Estimates of special entity market participants in our economic baseline are based on manual account classifications, and our data is not sufficiently granular to estimate the number of special entities defined in but not subject to ERISA currently active in security-based swap markets that may be scoped in by these rules. Special entities represent approximately 8% of market participants in swap markets.[1696] Out of 3,635

[1696] This estimate is based upon data provided by ISDA as of December 31, 2015 on the number and type of market participants adhering to the ISDA August 2012 DF Protocol. See Memorandum from Lindsay Kidwell to File (Feb. 18, 2016)

special entities subscribed to the ISDA August 2012 DF Protocol, 1,453 market participants (approximately 40%) elected to be a special entity under the protocol. This may indicate that a substantial number of market participants in swap markets may have opted into the special entity treatment. However, we note that using hand classifications of accounts in TIW data on 2006-2014, we estimate that special entities represent approximately 10.5% of single name CDS market participants by count (see Table 2 above). This estimate is comparable to the 8% of all special entities adhering to the ISDA August 2012 DF Protocol, and our hand classifications of accounts do not distinguish between special entities subject to ERISA, and those defined in but not subject to ERISA. Therefore, our analysis of special entity transaction activity throughout the release likely includes both special entities subject to ERISA, and entities defined in but not subject to ERISA that may opt out of the special entity protections of these final rules.

Special entity requirements and related costs will not apply to security-based swaps transacted on registered national securities exchanges and registered or exempt SEFs, if the SBS Entity does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rules. We recognize that some security-based swaps executed on a SEF or exchange may be bilaterally negotiated, which may point to potential counterparty and information benefits of applying the business conduct rules to SEF and exchange traded security-based swaps. However, bilateral negotiations are likely to

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available on the Commission's website at http://www.sec.gov/comments/s7-25-11/s72511.shtml under "Meetings with SEC Officials." See also Section VI.B.

require an SBS Entity to know the identity of the counterparty at a reasonably sufficient time prior to execution to permit compliance. We also recognize that conflicts of interest may affect SBS Dealer recommendations of security-based swaps regardless of the venue in which these transactions are executed. It is not clear whether an SBS Dealer would be able to make a recommendation to a counterparty whose identity is not known at a reasonably sufficient time prior to execution. Finally, as we discuss throughout the release, while business conduct rules, including rules concerning special entities, may result in significant benefits, they will impose direct and indirect costs on SBS Entities. In the context of SEF transactions, the application of these rules may increase transaction costs, add complexity and delays, or require negotiation with counterparties. To the extent that security-based swaps executed through SEFs may represent exclusively arms-length transactions, the terms of which are not negotiated, the imposition of the final business conduct rules on such trades could increase costs without corresponding benefits anticipated by these final rules. For instance, if clearing reduces credit risk of counterparties, SBS Entities may compete on transaction costs and quality of execution, as opposed to credit risks of the transaction, as suggested by commenters.[1697] These final rules recognize these competing considerations and provide explicit relief for transactions executed on a registered or exempt SEF or registered national exchange, if the SBS Entity does not know the identity of the special entity counterparty at a reasonably sufficient time prior to execution of the transaction to permit compliance with the obligations of the rule. Finally, the Commission continues to recognize that the benefits of these final special entity rules are expected to primarily accrue to entities that are less

[1697] See SIFMA (August 2011), supra note 5 and BlackRock, supra note 5.

informed about security-based swap markets. While special entities will not be able to opt out of the protections of these final rules as discussed in section VI.C.8, SBS Entities will be able to rely on an independent representative safe harbor, the economic effects of which are considered in detail in the sections that follow.

As discussed in Section II, the special entity definition does not include collective investment vehicles, and the final rules do not require SBS Dealers to determine whether any of the investors in the collective investment vehicle counterparty qualify as special entities. Such an approach limits the scope of application of these final rules, reducing potential counterparty protection and allocative efficiency benefits, but also potential costs and risks of loss of access by special entities and entities defined in, but not subject to ERISA, to security-based swaps.

b. <u>SBS Entities as Counterparties to Special Entities</u>

Under final Rule 15Fh-5(a) an SBS Entity that offers to enter or enters into a security-based swap with a special entity must have a reasonable basis to believe that the special entity has a qualified independent representative. Under Rule 15Fh-5(c), before initiating a swap, an SBS Dealer will also be required to disclose in writing the capacity in which the dealer is acting in connection with the security-based swap. Additionally, if the SBS Dealer or its associated persons engage or have engaged in business with the special entity in more than one capacity, the dealer would be required to disclose the material differences between such capacities and any other financial transactions or service involving the special entity. As discussed in section II.H.7 supra, the SBS Dealer may use generalized disclosures regarding the capacities in which the SBS Dealer and its associated persons have acted or may act with respect to the special entity, along with a

statement distinguishing those capacities from the capacity in which the SBS Dealer is acting with respect to the present security-based swap. The requirements in Rule 15Fh-5 do not apply to a security-based swap if the transaction is being executed on a registered or exempt SEF or registered national securities exchange, and the SBS Entity does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit compliance with these obligations.

Qualified independent representatives must have sufficient knowledge to evaluate the transaction and risks; may not be subject to statutory disqualification; undertake a duty to act in the best interests of the special entity; appropriately and timely disclose material information concerning the security-based swap to the special entity; evaluate, consistent with any guidelines provided by the special entity, the fairness of pricing and appropriateness of the security-based swap; and for certain types of special entities the representative must be subject to rules for the Commission, the CFTC, or a SRO prohibiting it from engaging in specified activities if certain political contributions have been made, unless the representative is an employee of the special entity. Independence requires that a 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. A representative will be deemed to be independent of an SBS Entity if, within one year of representing the special entity in connection with the security-based swap, the representative was not an associated person of an SBS Entity; provides timely disclosures to the special entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the special entity; complies with policies

and procedures reasonably designed to manage and mitigate such material conflicts of interest; and the SBS Entity did not refer, recommend, or introduce it to the special entity within one year of the representative's representation of the special entity in connection with the security-based swap. As proposed by some commenters, ERISA plans will be able to comply with these requirements by relying on an ERISA fiduciary.[1698] Further, as we discuss in more detail below, the independence requirement refers to the representative's independence of the SBS Entity and not of the special entity and so, qualified investment representatives that are employees or associates of the special entity may qualify as independent representatives for the purposes of these rules.

In contrast with the final rule, the proposed rule defined independence based on a two-prong test of 1) associated person status within the preceding year; and 2) ten percent or greater revenue reliance on a given SBS Entity. We are sensitive to commenter concerns that this definition may impose undue restrictions and cost burdens on SBS Entities, and may be difficult to implement.[1699] Further, the CFTC's independence formulation applicable to Swap Entities does not include a ten percent revenue prong in the independent test with special entities. In light of active cross-market participation and expected SBS Entity cross-registration, adopting a substantively different independence requirement from that required by Swap Entities may impose costs of compliance with two different independent representation standards. At the same time, it is unclear that

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1698 See ABC, supra note 5 and SIFMA (August 2011), supra note 5.

1699 See, e.g., SIFMA (August 2011), supra note 5; APPA; BlackRock, supra note 5; SIFMA (August 2011), supra note 5; ABA Committees, supra note 5; FIA/ISDA/SIFMA, supra note 5; Blackrock, supra note 5.

such an approach would be more beneficial to counterparty protections, Commission oversight or enforcement in security-based swaps relative to the approach being adopted.

Under this rule, special entities transacting with more informed and sophisticated SBS Entities will have the benefit of representation by a qualified independent representative that has a duty to act in the best interests of the entity. To the extent that some special entities are less informed about security-based swaps and less able to unwind biases that may exist in potentially conflicted recommendations than other counterparties, this requirement may appropriately facilitate stronger protections and superior capital allocation decisions by special entities. Better informed special entities, such as large well-informed pension funds that regularly transact in security-based swaps, are likely to enjoy fewer benefits of this requirement. However, they may also be more likely to use investment advisers in their current security-based swap transactions, in which case they would need to make that representation to an SBS Dealer under Rule 15Fh-5(b). In addition, similar to our earlier discussion of suitability rules, to the extent that special entities may be entering security-based swap transactions with inferior risk-return characteristics as a result of internal incentive conflicts or macro factors, such as reaching for yield in a low interest rate environment, the benefits of these protections may be muted.

Further, special entities that transact with the SBS Dealer in a variety of roles, such as investment adviser or underwriter, will benefit from greater transparency about the capacity in which the dealer is entering the security-based swap. For instance, if an SBS Dealer currently engages in business with a special entity in the capacity of an investment adviser, the SBS Dealer would be required to disclose that it is not acting in

such capacity if it is seeking to enter into a security-based swap with the special entity. This may help counterparties better understand the nature of the incentives of an SBS Dealer in relation to a given security-based swap transaction.

This rule will involve direct and indirect costs. SBS Entity counterparties will incur costs of obtaining a reasonable basis to believe that the special entity has a qualified independent representative. Based on our estimates in Section V, all SBS Entities acting as counterparties to special entities will incur an aggregate initial cost of, approximately, $132,819,500.[1700] Ongoing costs of compliance with rules for counterparties of special entities will involve updating representations and verifications for transactions with third-party non-employee independent representatives, estimated at $8,569,000.[1701] In-house independent representatives will bear costs of making representations to SBS Entities, which will involve an aggregate initial compliance burden of, approximately, $137,104,000 with an ongoing cost of $8,569,000.[1702]

In addition, some special entities may be entering security-based swaps with SBS Entities that are not in their best interest, and advice from qualified independent representatives may help inform special entities and enable them to make better investment decisions. Therefore, this rule may improve allocative efficiency of security-

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[1700] Aggregate initial cost: (In-house attorney at $380 per hour) x 349,525 hours = $132,819,500

[1701] Ongoing aggregate cost: (In-house attorney at $380 per hour) x 22,500 hours = $8,569,000

[1702] Initial cost: (In-house attorney at $380 per hour) x 360,800 hours = $137,104,000. We believe that in-house investment advisers may be compensated similarly to in-house attorneys. To the extent that the rate of compensation for independent representatives may be lower, these figures may overestimate the aggregate initial burden related to these final rules.

Ongoing: (In-house attorney at $380 per hour) x 22,500 hours = $8,569,000

based swap investments. However, as noted earlier, SBS Entities are for-profit entities, and, to the extent that SBS Entities are currently intermediating security-based swaps that are not in the best interests of some of their special entity counterparties, the rule may lower an SBS Entity's profitability of intermediating security-based swaps with special entities. SBS Entities may attempt to recoup these costs in the form of less attractive security-based swap terms, or become less willing to transact with special entities. As an additional consideration, entities with activity levels below de minimis triggering SBS Dealer registration, but with positions large enough to require Major SBS Participant registration will bear these costs of intermediating transactions with special entities. If the costs of intermediated security-based swaps with special entities are substantial, some Major SBS Participants may reduce or stop transacting with special entity counterparties.

These costs may be lower if SBS Entities' special entity counterparties provide representations that allow SBS Entities to take advantage of the safe harbor in Rule 15Fh-5(b). Our data do not allow us to estimate the number of special entities currently relying on qualified independent representatives since we cannot observe whether they have conflicts of interest with SBS Entities that would preclude them from meeting independence requirements of these final rules. However, we note that, as reflected in the economic baseline, special entities represent approximately 10.5% of account holders in DTCC TIW between 2006 and 2014. Only approximately 2% of special entities did not rely on investment advisers in their single name CDS trades, with 85 unique pairs of SBS Dealers and U.S. special entities transacting in single name CDS. In 2014, there were 2 unique trading relationships between likely SBS Dealers and special entities without a third party investment adviser, representing approximately 0.039% of all

transactions in 2014. Therefore, the overwhelming majority of special entities may already be relying on investment advisers in their security-based swap transactions. However, we do not observe whether advisors in TIW data meet the independence and qualification requirements being adopted in these final rules. If a significant fraction of third party representatives does not meet the qualified independent representative requirements in these final rules, special entity counterparties of SBS Entities may choose to replace third party representatives with those that do have requisite qualifications and independence, enabling continued transaction activity with SBS Entities, or may lose access to SBS Entity intermediated OTC security-based swaps.

As estimated above, all special entity counterparties of SBS Entities will face costs of making representations to SBS Entities concerning their reliance on independent advisors acting in their best interests. To the extent SBS Entities transact with special entities that are not already relying on representatives, or are relying on representatives that would not meet the qualification and independence criteria in these final rules, such special entities would incur costs of obtaining a new representative and making necessary representations, if they wish to facilitate the SBS Entities' reliance on the safe harbor. This may increase demand for the services of qualified independent representatives, and independent representatives may require higher compensation to reflect such higher demand. Such costs will depend on the number of third-party representatives of special entities that do not currently meet the independence and qualification requirements of these final rules; the resulting increase in the demand for new representation; and the supply of investment advisers not currently representing special entities in security-based swaps that would be considered qualified and independent under these final rules. We

lack data to quantify these effects and commenters did not provide information that would enable such quantification. We are, therefore, unable to estimate these costs.

Under the final rules, SBS Entities may become counterparties of special entities only if they have a reasonable basis to believe that the special entity has a qualified independent representative. We note that Rule 15Fh-1(b) allows SBS Entities to rely on written representations of a counterparty to satisfy its due diligence requirements. As a result, SBS Entities that can rely on representations will not be required to conduct independent assessments of the qualifications or independence of special entity representatives, as proposed by some commenters.[1703] These issues are discussed in further detail in Section VI.C.4.iv below.

c. SBS Dealers as Advisors to Special Entities

Rule 15Fh-2(a) introduces in a default presumption that an SBS 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. The rule provides a safe harbor, where an SBS Dealer will not be acting as advisor when a special entity represents that it acknowledges that the SBS Dealer is not acting as an advisor, that the special entity will rely on advice from a qualified independent representative, and the SBS Dealer discloses to the special entity that it is not undertaking to act in the best interest of the special entity. The rule also provides a safe harbor for SBS Dealers transacting with ERISA special entities, where the SBS Dealer will not be acting as an advisor if the special entity represents that it has an ERISA fiduciary; the fiduciary represents in writing that it acknowledges that the SBS Dealer is not acting as an advisor;

[1703] See, e.g., SIFMA (August 2011), supra note 5.

and the special entity represents either that it will comply in good faith with written policies and procedures designed to ensure that any recommendation received from the SBS Dealer involving a security-based swap transaction is evaluated by a fiduciary, or that any recommendation received from the SBS Dealer involving a security-based swap transaction will be evaluated by a fiduciary.

Rule 15Fh-4(b) establishes requirements for an SBS Dealer acting as an advisor to special entities. Rule 15Fh-4(b)(1) provides that an SBS Dealer acting as an advisor to a special entity shall have a duty to make a reasonable determination that any security-based swap or trading strategy involving a security-based swap recommended by the SBS Dealer is in the best interests of the special entity. Rule 15Fh-4(b)(2) requires an SBS Dealer acting as an advisor to a special entity to make reasonable efforts to obtain such information that the SBS Dealer considers necessary to make such a determination.

The final rules except transactions executed on registered or exempt SEFs or registered national securities exchanges if an SBS Dealer does not know the identity of the counterparty at a reasonably sufficient time prior to execution to permit compliance with these final obligations.

As discussed in detail in earlier sections, SBS Dealers enjoy informational advantages relative to their nondealer counterparties, and are for profit entities with business interests that may conflict with those of their counterparties in principal and/or agency transactions. Hence, SBS Dealers may have conflicts of interest related to the

security-based swaps and the securities underlying them.[1704] Such conflicts of interest may influence SBS Dealer recommendations to their counterparties. The final business conduct rules may lessen the reliance of special entities on SBS Dealer recommendations, but, they may also limit special entities' access to security-based swap related investment advice and OTC security-based swaps.

Special entity counterparties may be aware of these fundamental incentives of SBS Dealers and of the complexity and opacity of security-based swaps, and may be able to recognize and parse out the potential bias in dealer recommendations. As discussed above, special entities represent a small fraction of market participants and almost exclusively rely on investment advisers. We also note that, to the extent special entities are currently allocating capital inefficiently in security-based swaps, they may be doing so for reasons unrelated to SBS Dealer recommendations, such as reaching for yield in a low interest rate environment, or as a result of fund manager incentive conflicts. If special entity participation in security-based swap markets is driven by these other factors and is not a result of reliance on SBS Dealer recommendations, the benefits of these rules may be reduced.

As we have noted in prior sections, based on TIW data for 2006 through 2014, approximately 98% of special entities transacting in single name CDS trades in TIW rely on advisors. We lack data to estimate how many of these advisors may be considered qualified independent representatives for the purposes of the safe harbor. However, we recognize that the economic effects of this rule may be significantly reduced if many SBS

[1704] See Sections VI.A and VI.C.2 for a more detailed discussion of informational asymmetries and conflicts of interest related to security-based swap dealing activity.

Dealers avail themselves of the safe harbor in their transactions with and recommendations to special entities.

We note that under the final rules, when an SBS Dealer makes a recommendation to a special entity, and obtains the representations and makes the disclosures required by the safe harbor, the SBS Dealer will not be required to comply with the best interest standard in Rule 15Fh-4(b). However, if, in such cases the special entity counterparty has less than $50 million in assets (and therefore, does not meet the institutional counterparty definition), the SBS Dealer will still be required to comply with its customer-specific suitability obligations in Rule 15Fh-3(f)(1)(ii). This provision imposes customer-specific suitability obligations on SBS Dealers who cannot take advantage of the institutional suitability alternative in Rule 15Fh-3(f)(2). This may enhance potential counterparty protection and allocative efficiency benefits of the final special entity rules relative to the alternative of not imposing customer-specific suitability obligations with respect to special entities under the safe harbor with less than $50 million in assets. Our data do not allow us to estimate how many special entities would fall under the $50 million asset size threshold; asset size thresholds for special entities at which the intended information and counterparty protection benefits of these final rules become significant; or the extent to which asset size and special entity sophistication may be correlated in security-based swap markets.

We also recognize that this approach diverges from the institutional suitability alternative adopted by the CFTC as part of business conduct standards for Swap Entities. As a result, all SBS Dealers that are dually registered with the CFTC as Swap Dealers will face two different standards of care in swaps and security-based swaps when making

recommendations to special entities with less than $50 million in assets. As a result, dually registered SBS Dealers may choose not to rely on the institutional suitability alternative when making recommendations to special entities with less than $50 million in both swap and security-based swap markets. This aspect of the alternative may increase costs that SBS Dealers will incur as a result of advising and transacting with small special entities in security-based swaps. SBS Dealers may reduce their provision of advice to small special entities or pass on such costs to counterparties in the form of higher transaction costs or a decreased willingness to intermediate over-the-counter security-based swaps. Further, as discussed above, the Commission believes that suitability obligations for special entities with less than $50 million in assets may increase the potential counterparty protection and allocative efficiency benefits of the final special entity rules. Therefore, the primary economic effects of these rules depend on the degree to which special entities rely on conflicted SBS Dealer recommendations in their security-based swap decisions, the value of biased security-based swap recommendations by SBS Dealers, the relative cost of outside investment advice concerning security-based swaps, and the fraction of SBS Dealers that will be able to take advantage of the qualified independent representative safe harbor.

Therefore, the primary economic effects of these rules depend on the degree to which special entities rely on conflicted SBS Dealer recommendations in their security-based swap decisions, the value of biased security-based swap recommendations by SBS Dealers, the relative cost of outside investment advice concerning security-based swaps, and the fraction of SBS Dealers that will be able to take advantage of the qualified independent representative safe harbor.

SBS Dealers will be unable to recommend security-based swaps that are not in special entities' best interests, and will therefore forego potential incremental profits from such transactions. SBS Dealer "best interest" determinations concerning recommended security-based swaps may potentially give rise to dealer liability or litigation risk if there are differences of opinion concerning the relative merits of different security-based swaps and counterparties incur losses. SBS Dealer registration is not currently required, disclosure of litigation reserves by SBS Dealers is not mandatory, and the economic magnitude of such costs will depend on how special entities, their representatives and SBS Dealers will respond to these final rules. Therefore, we are unable to estimate these costs. However, we recognize that some SBS Dealers may incur such costs. In addition, the aggregate initial costs of revising representations and collecting requisite information from special entities related to the requirements for SBS Dealers serving as advisors to special entities are estimated at $741,000.[1705]

SBS Dealers that are most affected by these costs may respond to the final rules by ceasing to provide security-based swap recommendations to special entities, limiting special entities' access to such investment advice, or by decreasing their willingness to intermediate OTC security-based swaps with special entities. However, we note that SBS Dealers that lose the most profit as a result of the requirement to provide advice in their counterparties' best interests may have been issuing more conflicted recommendations that were not in the special entities' best interests. Therefore, special entities may lose

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[1705] Initial cost: (In-house attorney at $380 per hour) x ((250 hours to draft, review and revise the representations in standard SBS documentation) + (1,700 hours to collect information from each special entity) = $741,000

access to such conflicted advice, but the remaining advice by SBS Dealers should be consistent with special entities' best interest.

d. Independent Representation: Alternatives

We have considered alternatives that result in tightening of the independence requirements for representatives, for instance, through the imposition of a longer look back period in the associated person prong of the independence definition. More stringent independence requirements may mitigate potential conflicts of interest and biases in security-based swap recommendations registered representatives make to special entities. However, as tabulated in Table 2, the majority of market participants rely on investment advisers for their security-based swap transactions, and more stringent definitions will limit the number of representatives qualified to advise special entities in security-based swaps. A decrease in the supply of independent representatives may increase the cost of retaining independent representation and limit access by smaller, less sophisticated counterparties that benefit from independent advice and representation in opaque and complex security-based swap transactions. Further, more stringent independence requirements may decrease the level of specialized expertise of representatives. We have received mixed comments on the relative merits of various definitions of independence, commenters did not quantify the economic costs or benefits of the alternatives[1706] and no such data is available at present time. As indicated earlier, the independence definition being adopted is consistent with the CFTC's approach in swap markets.

[1706] See, e.g., Better Markets (August 2011), supra note 5; NAIPFA, supra note 5; CFA, supra note 5; FIA/ISDA/SIFMA, supra note 5; APPA; BlackRock, supra note 5; SIFMA (August 2011), supra note 5; and Blackrock, supra note 5.

Finally, we have considered eliminating the independent representative safe harbor from the special entity requirements, as suggested by some commenters.[1707] To the extent that unsophisticated counterparties rely on independent outside advisors or professional portfolio managers acting in their best interest, the economic effects of potential biases in SBS Dealer recommendations may be mitigated. Sophisticated entities and entities relying on independent advice from qualified fiduciaries are less likely to benefit from SBS Dealer best interest recommendations, particularly in light of the disclosures being adopted as part of these final rules. At the same time, the costs of SBS Entity advice under the best interest standard would be passed on to special entities, increasing costs of security-based swaps and potentially limiting market access for special entities. Further, SBS Entities may have superior information about security-based swaps, but face information asymmetries concerning the nature of financial and business risks of their counterparties. Special entities may be better able to assess the relative merits of a given security-based swap transaction when relying on independent qualified representatives, as opposed to engaging SBS Entities to make such recommendations under a best interest standard.

Similarly, prohibiting SBS Dealers from selling derivatives when the special entity would be better served by more traditional debt instruments, as suggested by one commenter,[1708] will impede market access by special entities to a potentially valuable vehicle for risk mitigation. For some special entities, particularly for sophisticated entities, entities relying on independent advice from qualified advisors, and entities with

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[1707] Better Markets (August 2011), supra note 5; CFA, supra note 5; and AFSCME, supra note 5.

[1708] See CFA, supra note 5.

risk management needs best addressed by OTC security-based swaps, such costs are likely to be significant. Further, this alternative would preclude special entities from accessing one of the vehicles for trading on negative information about risks of the underlying securities. Excluding informed and sophisticated special entities from security-based swaps markets may decrease price efficiency and liquidity, and fragment swap, security-based swap and underlying reference security markets. However, if such special entities are prohibited from accessing OTC security-based swaps, these entities would be able to access standardized security-based swaps traded on registered national exchanges or SEFs. This may increase the volume of security-based swap trades transacted on these platforms.

e. Reliance on Representations

Rule 15Fh-1(b) allows SBS Entities to rely on the written representations of a counterparty to satisfy its due diligence requirements, unless they have information that would cause a reasonable person to question the accuracy of the representation. While these final rules impose new costs on SBS Entities, Rule 15Fh-1(b) will enable SBS Entities to rely on representations in lieu of independent due diligence, under certain circumstances. Since SBS Entities may be able to rely on representations to fulfil the requirements in these final rules, we expect they will do so when the costs of reliance on representations are lower than those of independent due diligence, to the extent that special entities are willing and able to provide representations that meet the requirements of the rule. This may, therefore, provide potentially beneficial flexibility to SBS Entities in managing their compliance obligations under these final rules.

Relying on special entities' representations concerning the qualifications, and independence of investment representatives should be less costly for SBS Entities than conducting independent substantive evaluations of qualifications and independence of their counterparties' representatives. To the extent that the best interest standard introduces costs for SBS Entities, and to the extent that the qualified independent representative safe harbor may mitigate these costs as discussed in prior sections, Rule 15Fh-1(b) may enable SBS Entities to make recommendations and serve as counterparties to special entities at lower costs under reliance on counterparty representations than under independent due diligence. However, if an SBS Entity has information that would lead a reasonable person to question the accuracy of the representation, SBS Entities will be required to perform independent due diligence.

We have considered an "actual knowledge" standard as an alternative to the reliance on representation standard. Under an "actual knowledge" standard, an SBS Entity can rely on a representation unless it knows that the representation is inaccurate. The alternative could allow SBS Entities to rely on questionable representations insofar as they do not have actual knowledge that the representation is inaccurate, even if they have information that would cause reasonable persons to question their accuracy. As a result, this alternative would reduce the benefits of the verification of status, know your counterparty, suitability and special entity requirements and result in weaker protections for counterparties to SBS Entities. However, SBS Entities would be able to rely on counterparty representations with respect to a potentially greater set of transactions and counterparties. To the extent that reliance on representations may lower SBS Entity costs

from these final business conduct rules, this actual knowledge standard alternative for reliance on representations has the potential to further reduce costs.

We have received mixed comments on the relative merits of these standards, with some commenters supporting the actual knowledge standard,[1709] others supporting the reasonable person reliance standard,[1710] and others opposing both standards as too low.[1711] None of the commenters quantified the potential economic costs or benefits of the proposed standards, and we lack information or data to quantify the above economic effects. For instance, we lack information about the number of transactions between special entities and SBS Entities conducted in reliance on representations, the accuracy of which reasonable persons would question but where SBS Entities lack actual knowledge of falsehood, and the costs of independently evaluating a representative's qualifications and independence which will depend on an individual SBS Entity's choice to perform due diligence in house and the efficiency of related internal business processes, or to retain a third party due diligence provider and the related choice of service provider. In addition, we have received comment that, where SBS Dealers are required to conduct independent due diligence, they may face potential litigation risk if they approve a representative who is subsequently determined to be lacking expertise, as well as potential litigation from representatives whom they have chosen to disqualify, which may discourage SBS Dealers from intermediating OTC security-based swaps with certain

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1709 See, e.g., SIFMA (August 2011), supra note 5; FIA/ISDA/SIFMA, supra note 5; CCMR, supra note 5; APPA, supra note 5; BlackRock, supra note 5); ABC (2011); ABA Committees, supra note 5.

1710 See, e.g., Better Markets (2011)

1711 See CFA, supra note 5 and AFSCME, supra note 5.

groups of counterparties.[1712] Commenters have not provided any information to enable us to quantify these costs and we have no data to enable such quantification.

We note that under CFTC rules, Swap Entities are subject to the reasonable person reliance standard being adopted in these final rules. We also note that swap and security-based swap markets are interconnected, market participants transact across these markets, and many SBS Entities are expected to be dually-registered as Swap Entities. If the same dealers face differential compliance costs of transacting over the counter with the same special entities in, for instance, single name and index CDS, dealing activity may flow to the market with lower compliance costs, potentially fragmenting price discovery and liquidity. Further, the standard being adopted is likely more timely and cost effective than an approach permitting no reliance on representations.

We have also considered alternative approaches involving a higher standard for reliance on representations or requiring SBS Entities to conduct an independent analysis of conflicts and qualifications of each independent representative of a special entity, with which they may be negotiating swaps. This approach may enhance SBS Entities' due diligence with respect to representatives of special entity counterparties, but may decrease the willingness or ability of SBS Entities to provide special entities with access to security-based swaps.[1713] As an additional consideration, we understand that most market participants in swap markets and Swap Entities have adopted a multilateral protocol as a means of complying with the CFTC external business conduct rules. While we understand that the representations contained in the protocol only expressly address

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1712 See ABC, supra note 5.

1713 See, e.g., NAIPFA, supra note 5.

swap transactions, we have received comment that factual matters addressed by those representations typically do not vary between swap and security-based swap transactions. To the extent that cross-market participation of dealers and non-dealer counterparties is a significant feature of security-based swap markets, requiring dually-registered SBS Entities to obtain separate representations or conduct independent due diligence specifically addressing security-based swaps may impose additional costs, which may be passed on to counterparties and limit their access to OTC security-based swaps.[1714] In addition, as discussed above, we have received comment that requiring SBS Dealers to conduct independent due diligence may lead to potential litigation risk from approving representatives subsequently determined to be lacking expertise or representatives that are disapproved. According to the comment letter, this may discourage SBS Dealers from intermediating OTC security-based swaps with certain groups of counterparties. [1715] The commenter did not provide any estimate of such potential costs and the Commission has no data to enable such quantification. However, we recognize that these costs may be significant, and it is unclear that the independent due diligence alternative is superior to the reliance on representation approach being adopted.

f. Magnitude of the Economic Effects

When considering the likely magnitude of the economic effects of special entity rules discussed above, we note that, based on data for November 2006 through December 2014, approximately 98% of special entities relied on investment advisors for their single name CDS trades in DTCC-TIW, and only approximately 2% of special entities acted as

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[1714] See SIFMA (November 2015), supra note 5

[1715] See ABC, supra note 5.

a transacting agents.[1716] We lack data or other information to estimate how many investment advisers currently representing special entities in security-based swap markets will be considered qualified and independent for the purposes of compliance with these final rules, or how many SBS Entities would be able to rely on the independent representative safe harbor in their transactions with special entities. Commenters did not provide data that would enable such quantification. In addition, we lack data on the associations of investment advisers with SBS Entities in the past year, the extent of their advisory roles in relationships with special entities, the existence of conflicts of interest, and other information. Therefore, we cannot quantify how many special entities may be able to rely on representations. However, in light of special entities' heavy reliance on investment advisers in security-based swap transactions, it is unclear whether a substantial portion of special entities rely on SBS Entity recommendations in their security-based swap transactions.

We also recognize similarities between the CFTC's business conduct standards, FINRA rules, and the rules being adopted, as well as extensive cross-market participation -- all of which may reduce both the economic costs (if dually registered entities have already restructured their compliance infrastructure to comply with similar rules) and the benefits of these rules (if, for instance, special entities have learned about potential biases in recommendations from new market practices of the same dealers in other financial markets). We note that our final business conduct standards include transaction level requirements. Therefore, as we discuss and estimate above, some benefits and costs

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[1716] Approximately 95% of special entities relied on SEC registered investment advisers, and another 3% of special entities used unregistered investment advisers. See Table 2 of the economic baseline, Section VI.B supra.

related to individual security-based transactions are still likely to accrue to special entities, their qualified independent representatives, and SBS Entities; even those already subject to similar rules in other markets. Further, some SBS Entities and potential new entrants may not be cross-registered with the CFTC or with FINRA, and may, therefore, not already be subject to similar rules in other markets.

Finally, the rules relating to transactions with special entities will not apply to security-based swaps executed on registered or exempt SEFs or registered national security exchanges, where SBS Entities do not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the SBS Entity to comply with the obligations of the rules. Therefore, special entities would not receive the benefits of additional counterparty protections of these rules when transacting anonymously through SEFs or registered national securities exchanges. However, as noted earlier these final rules may increase the costs of SBS Entities and reduce their information rents, which may lead SBS Entities to seek to recover lost profits through more adverse terms of OTC swaps sold to special entities, or reduced willingness to transact with special entities. Since anonymous SEF or exchange traded security-based swaps will not be subject to these final requirements, the risk that special entities will lose access to security-based swaps may be reduced.

5. Fraud, Fair and Balanced Communications, Supervision

a. Antifraud

The final business conduct rules include a set of antifraud provisions covering SBS Entity transactions with all counterparties, and with special entities. With respect to special entities, rules 15Fh-4(a)(1) and 15Fh-4(a)(2) prohibit SBS Entities from

employing any device, scheme, or artifice to defraud special entities, and from engaging in any transaction, practice or course of business that operates as a fraud or deceit. Rule 15Fh-4(a)(3) imposes a general ban on SBS Entities engaging in any act, practice, or course of business that is fraudulent, deceptive or manipulative.

To the extent fraudulent, deceptive or manipulative conduct may affect the choice of the SBS Entity's counterparty and the decision to enter into a given swap, antifraud protections may lead to an increased flow of transactions to SBS Entities not engaging in fraudulent practices. To the extent that the risk of fraud may affect the willingness of market participants to transact in security-based swap markets, antifraud protections may increase the willingness of non-SBS or Swap Entity counterparties to participate in security-based swap markets. We recognize that, as indicated by a commenter, general antifraud and anti-manipulation provisions of existing federal securities laws and Commission rules offer similar protections.[1717] Therefore, the magnitude of these economic benefits relative to the economic baseline is expected to be de minimis. Further, in light of SBS Entities' ongoing statutory antifraud obligations, we anticipate that entities likely to trigger SBS Entity registration requirements have already developed policies and procedures necessary for compliance with these final rules. Therefore, the magnitude of the economic costs to SBS Entities from these final rules is expected to be de minimis as well.

The Commission is not establishing a policies and procedures safe harbor for non-scienter violations, or provisions regarding the protection for counterparty confidential information. As an alternative to these final rules, the Commission could adopt such a

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[1717] See Barnard, supra note 5.

safe harbor. For instance, the Commission could adopt a rule where an SBS Entity would be able to establish an affirmative defense by demonstrating that it did not act intentionally or recklessly, and complied in good faith with written policies and procedures reasonably designed to meet this particular requirement. The adoption of such a safe harbor may reduce compliance and litigation costs related to nonscienter fraudulent, deceptive or abusive practices or conduct that may occur despite SBS Entities having developed and implemented all relevant policies and procedures, acting in good faith. However, a safe harbor against fraud may weaken counterparty protections in a market for complex and opaque securities.

b. <u>Fair and Balanced Communications</u>

Under rule 15Fh-3(g), SBS Entities are required to communicate with counterparties in a fair and balanced manner based on principles of fair dealing and good faith. As discussed in Sections I and II, this rule is harmonized with FINRA's communications with the public rule. To the extent that up to 16 likely SBS Entities may be cross-registered as broker-dealers, some SBS Entities are already complying with these requirements with respect to securities transactions. Specifically, all communications must provide a sound basis for evaluating a given security-based swap or trading strategy, communications may not imply that past performance will recur, or make exaggerated and unwarranted claims. Rule 15Fh-3(g) clarifies the kinds of communications that would be consistent with fair dealing or good faith communications. In conjunction with the antifraud rules and enhanced disclosure requirements, the fair and balanced communications rule aims to provide transparency to market participants transacting with SBS Entities. To the extent to which counterparties of SBS Entities may

have asymmetric information or are less sophisticated, this requirement may help protect counterparties and improve their ability to select the most appropriate security-based swap and counterparty.

We recognize that the requirement may impose costs on SBS Entities. As indicated in Section V, the related initial aggregate costs are estimated at $917,400 for the industry, with ongoing costs of approximately $125,400. [1718]

c. Supervision

Rule 15Fh-3(h) requires SBS Entities to establish and maintain a supervision system and diligently supervise their business and the activities of their associated persons. At a minimum the supervisory system must (1) designate at least one person with supervisory authority for each type of a business in which the SBS Entity engages that requires registration as an SBS Entity; (2) use reasonable efforts to determine that all supervisors are qualified; and (3) establish, maintain and enforce written policies and procedures addressing the supervision of the types of security-based swap business an SBS Entity is engaged in and the activities of its associated persons, that are reasonably designed to prevent violations of applicable securities laws, and rules and regulations thereunder. The rule lists specific types of policies and procedures that must be included.

In addition, SBS Entities and their associated persons will not be deemed to have failed to diligently supervise if (1) the SBS Entity has certain written policies and procedures and a documented system for applying them that would reasonably be

[1718] Initial internal cost: (In-house attorney $380 per hour) x 330 =$125,400. Initial external legal counsel costs: $330,000 + $462,000 = 792,000. Ongoing costs: (In-house attorney $380 per hour) x 330 = $125,400.

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 (2) the SBS Entity or its associated person has reasonably discharged the duties and obligations required by such written policies and procedures and system, and did not have a reasonable basis to believe they were not being followed.

Lastly, SBS Entities have an obligation to promptly amend written supervisory policies and procedures when there are material changes to applicable securities laws, rules and regulations, or when there are material changes to the SBS Entity's business or supervisory system. SBS Entities are also required to promptly communicate any material amendments to their supervisory procedures to all associated persons to whom such amendments are relevant based on their activities and responsibilities.

The Commission recognizes that these final supervision rules may impose certain burdens and costs on SBS Entities. Specifically, SBS Entities will be required to establish and maintain a supervision system consistent with the minimum requirements articulated in Rule 15Fh-3(h); to diligently supervise their business and the activities of their associated persons; and to amend their written supervisory policies and procedures when material changes occur to applicable laws, rules or regulations or to their business or supervisory systems, and promptly communicate such amendments to all associated persons to whom such amendments are relevant.[1719] Based on estimates in Section V, compliance with the supervision rules may involve an aggregate initial cost of

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[1719] See Section V for an estimate of burdens and costs related to the diligent supervision rules.

$39,317,850 and an ongoing cost of $8,405,100 for all SBS Entities.[1720] In addition, these final rules impose new supervision requirements on SBS Entities, which may increase the probability and related costs of responding to legal actions. However, to the extent that these supervision rules may enhance compliance with federal securities laws and Commission rules and regulations thereunder, the probability and costs of responding to regulatory inquiries and private actions may actually decrease.

We have considered the alternative of excluding Major SBS Participants from the scope of the supervision rules and have received mixed comment on the issue, as discussed in Section II. One commenter indicated that the rule may impose burdensome and costly supervisory procedures on Major SBS Participants that are not appropriate given their non-dealer role in the marketplace, and the potential costs of compliance "would be without any meaningful offsetting benefit for other market participants or the financial markets as a whole."[1721] The commenter did not provide any data to quantify potential costs or benefits for Major SBS Participants. We recognize that these rules impose requirements and costs on Major SBS Participants they are not currently required to bear, as reflected in our estimates. We also note that the Commission elsewhere estimated that only between zero and five entities may seek to register with the Commission as Major SBS Participants. The Commission continues to believe that due to their large positions in security-based swaps, activities of Major SBS Participants may pose significant risks, such as market and counterparty risks, in security-based swap

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[1720] Initial internal cost: (Compliance manager $283 per hour) x 103,950=$29,417,850. Initial external legal counsel costs: $9,900,000. Ongoing costs: (Compliance manager $283 per hour) x 29,700 = $8,405,100.

[1721] See MFA, supra note 5.

markets, as discussed in Section II above, the Commission believes the application of the rules is thus appropriate.

6. CCO Rules

Rule 15Fk-1 requires an SBS Entity to designate a CCO, and imposes certain duties and responsibilities on that CCO, including the preparation of an annual compliance report. In addition, under Rule 15Fk-1(d), the compensation and removal of the CCO require the approval of a majority of the board of directors of the SBS Entity. We note that the adopted SBS Entity registration forms already require SBS Entities to designate an individual to serve as a CCO, which enters into an economic baseline against which we are assessing the effects of these final rules. Therefore, the primary economic effects of these final CCO rules stem from the annual compliance report requirement, other duties of the CCO, and CCO compensation and removal requirements.

a. Annual Compliance Report, Conflicts of Interest, Policies and Procedures

Rule 15Fk-1(c) requires each SBS Entity's CCO to prepare and sign an annual compliance report containing a description of the SBS Entity's written policies and procedures described in paragraph (b) of the rule, including the code of ethics and conflict of interest policies. The report must also contain a description of: the SBS Entity's assessment of the effectiveness of its policies and procedures relating to its business as an SBS Entity; any material changes to the SBS Entity's policies and procedures; any areas for improvement, and recommended potential or prospective changes or improvements to the SBS Entity's compliance program and resources devoted to compliance; any material non-compliance matters; and the financial, managerial, operational, and staffing resources set aside for compliance with the Exchange Act and

the rules and regulations thereunder relating to its business as an SBS Entity, including any material deficiencies in such resources. Further, SBS Entities must promptly submit an amended compliance report if material errors or omissions in the report are identified. The submission of the annual compliance report as required by the final rules may help the Commission assess the compliance activities of SBS Entities.

In addition, Rule 15Fk-1(b)(2) requires the CCO to take reasonable steps to ensure that the SBS Entity establishes, maintains and reviews policies and procedures reasonably designed to achieve compliance with the Act and the rules and regulations thereunder relating to its business as an SBS Entity by: reviewing the compliance of the SBS Entity; and taking reasonable steps to ensure that the SBS Entity establishes policies and procedures for the remediation and handling of non-compliance issues. Rule 15Fk-1(b)(3) requires the CCO, in consultation with the board of directors or senior officer, to take reasonable steps to resolve any material conflicts of interest that may arise; and Rule 15Fk-1(b)(4) requires the CCO to administer each policy and procedure required to be established under Section 15F of the Exchange Act and the rules and regulations thereunder.

Our final rules impose a set of duties and responsibilities on CCOs of SBS Entities. As described in the economic baseline and discussed in earlier sections, the Commission believes that a number of entities that will seek to register as SBS Entities may be dually registered, and may already be required to comply with some of these rules in swap or reference security markets. However, we note that SBS Entity registration is currently not required, and entities intermediating security-based swaps, including dually registered entities, are not required to comply with business conduct or CCO rules

relating to their business as an SBS Entity. Therefore, these rules impose a new set of requirements on a population of SBS Entity registrants as they pertain to security-based swap business. To the extent that CCO oversight may facilitate compliance, the above rules may enhance compliance of SBS Entities with federal securities laws and other Commission rules.[1722]

Based on our analysis in Section V, the establishment and administration of the policies and procedures required under Rule 15Fk-1 will involve a total initial cost of approximately $13,105,950, and an ongoing cost of approximately $2,801,700 per year for all SBS Entities.[1723] Ongoing costs of preparation of an annual compliance report by the CCO is estimated at approximately $2,480,775 for all SBS Entities.[1724]

In addition, these rules impose new requirements concerning CCO duties. These final rules also require the annual compliance report to include a certification by the CCO or senior officer, and may increase CCO or senior officer liability when the CCO or senior officer executes the required certification. If SBS Entity CCOs or senior officers are risk averse, they may require additional liability insurance, higher compensation or lower incentive pay as a fraction of overall compensation. To the extent that liability

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1722 The Commission has elsewhere stated that strong internal compliance programs lower the likelihood of non-compliance with securities rules and regulations. See SDR Registration Release, 80 FR at 14543, supra note 1202.

1723 Initial cost of policies and procedures: (Compliance manager at $283 per hour) x 34,650 hours = $9,805,950. Initial cost of outside counsel: $3,300,000. Total initial cost: $9,805,950 + $3,300,000 = $13,105,950. Ongoing cost: (Compliance manager at $283 per hour) x 9,900 hours = $2,801,700.

1724 Ongoing cost of compliance reporting: (CCO at $485 per hour) x 5,115 hours = $2,480,775.

may be a significant consideration for some SBS Entities, this may lower the labor supply of senior officers or CCOs in security-based swap markets.

b. CCO Removal and Compensation

CCOs play a central role in monitoring compliance with federal securities laws and regulations. These final rules elevate approval of decisions regarding the compensation or removal of the CCO to the board. As indicated in the proposing release, the Commission believes that the approach being adopted may reduce inherent conflicts of interest that arise when CCO compensation and removal decisions are made by individuals whose compliance with applicable law and regulations the CCO is responsible for monitoring.[1725] The rule, therefore, may mitigate CCO conflicts of interest within SBS Entities, and may strengthen SBS Entity compliance with federal securities laws and Commission rules, including these final business conduct rules.

SBS Entities are expected to be primarily large institutions and may be part of organizational structures that include hundreds of entities, with varying levels of business complexity. Many SBS Entities may also be active in swap markets, while others may also perform broker-dealer functions or have banking operations; yet others may focus their primary business on security-based swaps. As a result, different governance and oversight structures may be suitable for different SBS Entities depending on their internal operations, business complexity, and the role security-based swap transactions play in their overall operations, among others. Therefore, the rule limits the ability to delegate CCO compensation and removal decisions to a senior officer, which may be optimal for some SBS Entities.

[1725] See Proposing Release, 76 FR at 42451, supra note 3.

CCO compensation and removal decisions require an understanding of security-based swap markets and the SBS Entities' business opportunities in such markets, compliance risks related to various SBS Entity activities and transactions, the labor market for CCOs of SBS Entities, and an ability to infer the quality of skills and effort exerted by the CCO from performance. To the extent SBS Entity boards lack specific expertise necessary to approve compensation and removal decisions, such boards may currently delegate these functions to other officers, such as head of compliance, chief risk officer, or other persons. As a result of the final rules, such delegation will not be permitted, and boards of some SBS Entities may be required to gather additional information or gain expertise necessary to approve compensation and removal decisions.

SBS Entities that currently delegate these functions to other officers may need to refocus board resources on the area of compliance. As a result, SBS Entity boards may need to replace existing directors, hire new directors, or retain the services of independent executive search and compensation consultants that are familiar with security-based swaps. This may detract from the time and resources SBS Entity boards are able to invest in overseeing activities in other markets, which may represent a larger fraction of the business and shareholder profits for some SBS Entities. To the extent that SBS Entity boards face time and resource constraints, they may also become less effective at monitoring and advising SBS Entities in areas outside of compliance. Further, the requirement that SBS Entity boards approve CCO compensation and removal decisions, may increase the liability of SBS Entity's directors, which may increase the costs of director liability insurance and director compensation. Nevertheless, as discussed above, the Commission continues to believe that these final rules may reduce certain conflicts of

interest related to CCO compensation and removal decisions, which may strengthen SBS Entity compliance with federal securities laws and Commission rules.

The final rules do not address the appointment of the CCO. However, the rules require the CCO to report directly to the board or senior officer, and require decisions regarding the compensation and removal of the CCO to be approved by the board. As a result, some SBS Entities may separate reporting to and appointment by the senior officer, from compensation and removal decisions by the board. The Commission recognizes that appointment, compensation and removal decisions may be inextricably intertwined, requiring an informed assessment of the CCO's talent, abilities, expertise and performance when compared against external candidates, as well as an understanding of the CCO labor market. Further, a senior officer may have conflicts of interest in CCO appointment decisions similar to those present in CCO compensation or removal decisions. A potential separation of the CCO reporting line and appointment decisions from compensation and removal decisions may decrease the quality of these decisions. However, the ability of some SBS Entity boards to continue to rely on senior officers for the CCO to report to and for appointment decisions may mitigate some of the resource drain on boards of SBS Entities discussed above.

We have considered an alternative approach under which only independent members of the board can approve decisions regarding the compensation, appointment and removal of CCOs, as proposed by some commenters,[1726] as well as requiring certain minimum CCO qualifications and governance practices. Independent directors may have fewer conflicts of interest and may be less likely to be influenced by CCOs, strengthening

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[1726] See, e.g., Barnard, supra note 5 and Better Markets (August 2011), supra note 5.

their oversight role, which may enhance SBS Entity compliance with security laws, and rules and regulations thereunder. At the same time, outside directors face an informational asymmetry with respect to the SBS Entity's risks and investment opportunities, and may lack an intimate understanding of the SBS Entity's business. We understand that SBS Entities may trade off the value of specific expertise in security-based swaps on the one hand, with the value of independence in the face of potential conflicts of interest on the other hand, in the context of each SBS Entity's operations. Requiring specific CCO qualifications and other governance practices of all SBS Entities may enhance compliance for some SBS Entities, but may also involve potentially costly restructuring of internal governance structures and operations while offering few benefits for other SBS Entities as recognized by one commenter.[1727]

Additionally, appropriate CCO qualifications may depend on the CCO's functional roles and expertise, and business activities that the SBS Entity engage in, particularly for SBS Entities that operate within larger consolidated financial institutions with the same CCO. One-size-fits-all qualification requirements or competency exams would restrict the level and type of expertise of CCOs that SBS Entities are able to retain, and would require some SBS Entities to remove the current CCOs and search for new CCOs meeting the imposed qualification requirements. Crucially, it is not clear how many SBS Entities currently hire and retain underqualified CCOs. The Commission is not requiring any particular level or type of competency or business experience for a CCO as part of these final rules. However, as discussed in Section II, the Commission believes that an SBS Entity's CCO generally should be competent and knowledgeable

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[1727] See FIA/ISDA/SIFMA, supra note 5.

regarding the federal securities laws, empowered with full responsibility and authority to develop appropriate policies and procedures for the SBS Entity, as necessary, and responsible for monitoring compliance with the SBS Entity's policies and procedures adopted pursuant to rules under the Exchange Act. Similarly, mandatory quarterly or annual meetings with the board or certain committees of SBS Entities, proposed by one commenter, [1728]may not mitigate potential conflicts of interest involving CCOs, or facilitate compliance where such conflicts or deficiencies stem from board or committee collective action problems, weak monitoring or misaligned incentives, instead of a lack of communication or information. .

As discussed in Section II, commenters disagreed on the relative merits of the approach being adopted and the alternatives above.[1729] The above economic effects are not readily amenable to quantification. Commenters did not provide data or other information that would facilitate quantification of these effects; no such data is publicly available. The overall effects of these competing considerations regarding the CCO rules being adopted depend on internal governance structures of SBS Entities, their organizational complexity, severity of the conflicts of interest between SBS Entity CCOs and other officers, reliance of existing SBS Entity boards on external executive search and compensation consultants, importance of security-based swap performance and compliance for SBS Entity profitability and counterparty protections, optimal delegation of oversight, and the ways in which SBS Entities may restructure their business in response to these and other pending substantive Title VII rules.

[1728] See Better Markets (October 2013), supra note 5.

[1729] See, e.g., FIA/ISDA/SIFMA, supra note 5, Better Markets, supra note 5; CFA, supra note 5. Also see Section II.I supra

7. **Pay to Play**

Rules 15Fh-5(a)(1)(vi) and 15Fh-6 impose a two-year time out period after certain political contributions by security-swap dealers and certain independent representatives. Rule 15Fh-6(b) generally prohibits SBS Dealers from offering to enter into, or entering into, a security-based swap or trading strategy involving a security-based swap with a municipal entity within two years following any contribution to an official of such municipal entity made by the SBS Dealer or any of its covered associates. The rule also prohibits SBS Dealers and any covered associates from providing or agreeing to provide payment to any person to solicit a municipal entity to offer to enter into, or to enter into, security-based swaps, unless such person is a regulated person. The rule prohibits SBS Dealers and any covered associates from coordinating or soliciting any person or political action committee to make contributions to officials of a municipal entity, or to a political party of a state or locality, with which the SBS Dealer is offering to enter into, or has entered into, a security-based swap or a trading strategy involving a security-based swap.

Under Rule 15Fh-6(a)(2) covered associates will include general partners, managing members, executive officers or other persons of similar status or function; employees who solicit municipal entities to enter security-based swaps with an SBS dealer, and all persons directly or indirectly supervising such employees; and political action committees controlled by such persons or SBS Dealers.

These final rules also limit political contributions by independent representatives in security-based swaps. Under Rule 15Fh-5(a) SBS Entities who offer to enter into or enter into a security-based swap with a special entity must have a reasonable basis to

believe that the special entity has a qualified independent representative. Rule 15Fh-5(a)(1)(vi) provides that in the case of a special entity, a qualified independent representative is a person that is subject to rules of the Commission, the CFTC or an SRO prohibiting it from engaging in specified activities if certain political contributions have been made, except where the independent representative is an employee of the special entity.

As discussed in more detail below, our economic analysis of these final rules reflects the fact that a large majority of entities expected to seek registration as SBS Entities are expected to be dually registered and required to comply with similar pay to play rules in other markets.

These final rules are intended to address pay to play relationships that may interfere with the process by which municipal entities allocate capital to security-based swaps to enhance returns or manage risk on behalf of their stakeholders.[1730] To the extent that these final rules reduce the incidence of pay to play practices, municipal entities may become less subject to conflicts of interest related to political contributions by SBS Dealers. To the extent that conflicts of interest related to political contributions may currently be affecting capital allocation by municipal entities, resulting in inefficiencies from conflicted counterparty or product selection, these rules may benefit municipal entities and their stakeholders. Consistent with the expected benefits articulated in the proposing release, these rules may deter undue influence from SBS dealers and advisors. Therefore, these rules may enhance counterparty protections of municipal entities and increase allocative efficiency. In addition, these rules may also encourage SBS Dealers

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[1730] See Proposing Release, 76 FR at 42450, supra note 3.

to compete on the merits of the transaction. Similarly, under Rule 15Fh-5 qualified independent representatives of special entities in security-based swaps will be employees and representatives subject to pay to play rules of the Commission, the CFTC or an SRO, such as registered municipal advisors or registered investment advisers. To the extent that some special entities may currently rely on advisors that are not employees or registered investment or municipal advisors, special entities may become less affected by potential conflicts of interest of representatives, and independent representatives may be encouraged to compete on their qualifications, service quality, and cost. These benefits may flow through to stakeholders of municipal entities, such as participants in public pension plans and taxpayers.

To the extent that SBS Dealers are currently recovering the costs from pay to play practices in the form of higher prices of security-based swaps, these final rules may decrease transaction costs. We have no data or other information on the prevalence of political contributions of SBS Dealers, the number and contributions of their covered associates, and transaction costs and non-price terms of security-based swaps offered for sale to special entities. Such data is not publicly available and commenters have not provided data to enable such quantification. However, a study by Butler, Fauver and Mortal (2009) found that negotiated bid deals had underwriter gross spreads of 12–14 basis points (about one-seventh of the mean gross spread) higher during the pay-to-play era.[1731] The study concluded that, when underwriting firms were routinely able to make

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[1731] See Alexander W. Butler, Larry Fauver, and Sandra Mortal, Corruption, Political Connections, and Municipal Finance, 22 The Review of Financial Studies 28-73 (2009).

political campaign contributions to win underwriting business, gross spreads were significantly higher, but only for those deals that were negotiated that enable conflicted underwriter selection. This may indicate that, absent pay to play rules, offerings subject to conflicts of interest related to political contributions may not always be negotiated at market rates. Pay to play rules may decrease certain costs to municipal entities and their stakeholders, but may increase costs to dealers from greater quality based competition.

Several caveats apply. While the pay to play regime considered in the study above examines the effects of the contribution limits in the 1994 pay to play reforms, and the contribution thresholds in these final rules are comparable in magnitude, we cannot quantify the levels at which certain political contributions by SBS Dealers and their covered associates may give rise to conflicts of interest. However, we note that de minimis thresholds in the final rules have been harmonized with existing rules to which Swap Entities and investment advisers are subject. We also note that the effect on spreads quantified above has been estimated around the adoption of the MSRB pay to play rule. These final rules follow pay to play rules adopted by the MSRB, the CFTC and the Commission. In light of extensive cross-market participation and expected dual registration of some entities, the economic effects of these final rules may be smaller than those discussed above, if some SBS Dealers and other market participants have already restructured their business practices in security-based swap markets as a result of existing pay to play rules in other markets.

In a theoretical model by Cotton (2012), contributions may increase access but not necessarily improve outcomes for some agents, while contribution limits decrease rent extraction and may encourage more evidence disclosure. *See* C. Cotton, Pay-to-play Politics: Informational Lobbying and Contribution Limits When Money Buys Access, 96 Journal of Public Economics 369-386 (2012).

Finally, the two-year time out may disincentivize direct political contributions to certain officials by SBS Dealers and their covered associates. To the extent that SBS Dealers and covered associates may increase contributions to other entities, such as 501(c) organizations[1732] or independent expenditure committees, which are not subject to these final rules, and to the extent these other expenditures may facilitate ongoing pay to play practices, the above benefits may be reduced.

As a result of the pay to play rule, SBS Dealers will incur costs, including costs of establishing and implementing policies and procedures to monitor the political contributions made by the SBS Dealer and its covered associates. As indicated in Section V, pay to play rules will require collection of information regarding political contributions of SBS Dealers and their covered associates, which may cost up to $3,515,000 for all dealers.[1733] Additionally, as discussed in Section V above, SBS Dealers may incur one-time initial costs to establish or enhance current systems to assist in their compliance with the rule, estimated at up to $5,000,000 for all SBS Dealers.[1734] Compliance costs imposed by the rule are expected to vary significantly among SBS Dealers, depending on, among other things, the number of covered associates and the

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1732 See, e.g., McCutcheon v. Federal Election Commission, 134 S.Ct. 1434, 1460 (2014).

1733 Initial cost: (In-house attorney at $380 per hour) x 9,250 hours = $3,515,000. This figure may overestimate the initial cost burden on some SBS Dealers if some of the functions are performed by in-house compliance managers instead of in-house attorneys.

1734 In the Advisers Act pay to play rule, the Commission estimated that firms with over 15 covered associates incur, on average, $100,000 startup costs. Assuming all SBS Dealers will have over 15 covered associates, the initial cost is estimated at: 50 SBS Dealers x $100,000 = $5,000,000. See Advisers Act Pay-to-Play Release, supra note 1100 (adopting Advisers Act Rule 206(4)-5)).

supervisory structure of the SBS Dealer; the degree to which compliance procedures are automated (such as policies and procedures requiring pre-clearance); and the extent to which the SBS Dealer may already have policies and procedures guiding political contributions under ethics or compliance programs. Smaller SBS Dealers, for example, would likely have a small number of covered associates, and thus expend fewer resources to comply with the proposed rule. However, to the extent that the cost of developing policies and procedures may have a high fixed cost component, smaller SBS dealers may incur costs that represent a higher percentage of net income. Lastly, these costs will be greater for SBS Dealers with multiple layers of supervision and a higher number of covered associates with shorter tenures.

Under the final rules, the two-year time out on SBS dealing with municipal entities is triggered when any of the covered associates has contributed in excess of the de minimis thresholds. While developing and implementing policies and procedures related to political contributions and training covered associates may mitigate this risk, some SBS Dealers may still trigger the time out despite these measures due to contributions by one of their covered associates.

Such SBS Dealers will incur costs from the loss of business with municipal entities. We note that the final rules contain a safe harbor for contributions by natural persons that predate the date of becoming a covered associate by more than 6 months, if such associates do not solicit municipal entities on behalf of the SBS Dealer. Further, if the SBS Dealer discovers the triggering contribution under $350 within 4 months and secures a return of funds within 60 days, the prohibition will not apply. In response to

commenter concerns,[1735] and consistent with Advisers Act Rule 206(4)-5, the final rules provide up to two such exemptions per year for dealers with 50 or fewer covered associates, and up to three such exemptions for dealers with over 50 covered associates. We do not have data or other information concerning the number of general partners, managing members, executive officers or other persons of similar status and function in SBS Entities; the number of employees that solicit municipal entities to enter security-based swaps with SBS Dealers; SBS Dealer supervisory structures for such employees; or political action committees controlled by such persons or SBS Dealers. However, the Commission has previously estimated that as many as 423 natural persons may associate with each SBS Dealer.[1736] Therefore, we believe that many SBS Entities are likely to be able to take advantage of up to 3 annual exemptions against inadvertent violations described above.

The final rules also allow SBS Dealers to file applications for exemptive relief, and outline a list of items to be addressed, including, whether the SBS Dealer has developed policies and procedures to monitor political contributions; the steps taken after discovery of the contribution; and the apparent intent in making the contribution based on the facts and circumstances of each case. These safe harbors, combined with the ability to apply for exemptive relief, may partly mitigate the direct and indirect costs of SBS Dealers triggering the timeout and being precluded from dealing with municipal entities.

As discussed in Section V, the incidence of exemptive relief related to MSRB Rule G-37 and the number of applications the Commission has received under the

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1735 FIA/ISDA/SIFMA, supra note 5.

1736 See Rule of Practice 194 Proposing Release, 80 FR at 51710.

Adviser's act pay to play rules may be indicative of possible applications for exemptive relief under these final rules. Recognizing that this is an estimate, we conservatively estimate that the Commission may receive up to two applications for exemptive relief per year with respect to pay to play rules, [1737] at a total ongoing cost of $25,600 per year.[1738]

Costs of compliance with the final pay to play rules may be recovered by SBS Dealers in the form of higher costs of security-based swaps offered to municipal entities. If the costs are significant and cannot be fully recovered from counterparties some SBS Dealers may limit their security-based swap transactions with municipal entities and reduce their access to OTC security-based swaps. However, the pay-to-play rules do not apply to security-based swaps executed on national registered exchanges or SEFs, where the security-based swap dealer does not know the identity of the counterparty to the transaction at a reasonably sufficient time prior to execution to permit the security-based swap dealer to comply. Therefore, municipal entities will retain access to more liquid and standardized security-based swaps executed on SEFs or registered national exchanges, and will continue to be able to rely on security-based swaps as a tool for risk mitigation.

[1737] FINRA has granted 17 exemptive letters related to Rule G-37 between 1/2005 and 12/2015 (11 years) http://www.finra.org/industry/exemptive-letters . As of 1/2016 there were 665 SEC registered muni advisers http://www.sec.gov/help/foia-docs-muniadvisorshtm.html. Using these figures, we obtain an estimate of (17 applications/11 years) x (50 SBS Dealers/ 665) = 0.117 applications per year.

In addition, the Commission has received 13 applications under the Adviser's act (since the compliance date, approximately 4 years). As of 2/2016 there were 11,959 registered investment advisers filing form ADV https://www.sec.gov/foia/docs/invafoia.htm. Using these figures, (13 applications/4 years) x (50 SBS Dealers/ 11,959)= 0.014 applications per year

[1738] Ongoing cost: (Outside counsel at $400 per hour x 32 hours per application x 2) = $25,600

Once SBS Dealers have to comply with the rule, to the extent that SBS Dealers currently engaging in pay to play practices enjoy a competitive advantage over SBS Dealers that are not, they may lose some of their business with municipal entities and related profits. However, other SBS Dealers that do not currently engage in pay to play practices may win business, and SBS Dealers may begin to seek competitive advantages through lower transaction costs, more customized security-based swaps, or superior execution, benefitting municipal entity counterparties.

If some SBS Dealers currently intermediating a significant volume of transactions with municipal entities trigger the two-year time out, it could limit the number of SBS Dealers able to offer to enter into or enter into security-based swaps with municipal entities. However, the lost market share is likely to be picked up by other SBS Dealers. The presence and direction of any economic effects would depend on the number of SBS Dealers that trigger the time outs; the market power of the prohibited SBS Dealers; the market power of SBS Dealers that may be able to step in; and the importance of bilateral relationships. Further, municipal entities will continue to have unconstrained access to security-based swaps transacted through SEFs or registered national security exchanges.

The Commission recognizes that these rules impose restrictions on persons that can represent special entities in security-based swap transactions of special entities with SBS Entities. As discussed in Section II.H.6.f, under Rule 15Fh-5(a)(1)(vi), qualified independent representatives of special entities must be subject to pay to play rules of the Commission, the CFTC or an SRO, except where the independent representative is an employee of the special entity. If special entities currently rely on advisors not subject to pay to play rules, or do not rely on independent advisors in their transactions with SBS

Entities in security-based swaps, they will incur costs related to retaining qualified independent representatives. These costs will depend on the type of advisor search the special entity would choose to perform, the special entity's ability to delegate such functions to current employees, and labor market conditions for qualified independent representatives. Table 2 of the economic baseline shows that the overwhelming majority of special entities transact through SEC registered investment advisers already subject to similar pay to play rules under the Adviser's Act. Special entities that do not transact through SEC registered investment advisers likely rely on municipal advisors subject to MSRB rules or employees in their transactions with SBS Entities. While we have no data or other information to enable us to identify what fraction of advisors representing special entities would meet the qualified independent representative requirements of these final rules, the above considerations indicate that costs of pay to play rules for independent representatives of special entities may be mitigated.

However, the Commission recognizes that, to the extent that some representatives currently intermediating special entity transactions with SBS Entities would be prohibited from advising special entities under these final rules, some representatives may incur costs related to loss of business, and competition among qualified independent representatives of special entities may decrease. At the same time, representatives prohibited from such activities under these final rules may seek to register as SEC registered investment advisers, MSRB registered municipal advisors or special entity employees, becoming subject to pay to play rules referenced in Rule 15Fh-5(a)(1)(vi) and continuing to represent special entities in compliance with these final rules. Therefore,

the overall effect of pay to play rules on competition among qualified independent representatives of special entities is unclear.

As a result of the two-year time out and other pay to play requirements, SBS Dealers transacting with municipal entities, as well as covered associates of SBS Dealers, may be less likely to make certain political contributions and payments to political parties at or above de minimis thresholds. This may result in a decrease in funding by SBS Dealers and their covered associates for such campaigns through direct contributions and political action committees. However, to the extent that the two-year time out may disincentivize direct contributions, SBS Dealers and covered associates may turn to other avenues of political speech, such as contributing unlimited amounts to 501(c) organizations or independent expenditure committees, which are not required to disclose donors and are not prohibited under these final rules.[1739] Therefore, the overall effect of these final rules on the aggregate volume of political contributions by SBS Dealers and their covered associates to campaigns is unclear.

As clarified in Section II, the Commission is adopting an approach, under which these prohibitions will not be triggered for an SBS Dealer or any of its covered associates by contributions made before the SBS Dealer registered with the Commission as such. We also note that these prohibitions will not apply to contributions made before the compliance date of the rule by newly covered associates to which the look back applies. At the same time, if individuals who later become covered associates make a triggering contribution on or after the compliance date of this rule, the contribution would trigger

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[1739] See, e.g., McCutcheon v. Federal Election Commission, 134 S.Ct. 1434, 1460 (2014).

the two-year time out if it were made less than, as applicable, six months or two years before the individual became a newly covered associate.

We have also considered the alternative, under which dealers would enjoy a safe harbor where the municipal entity is represented by a qualified independent representative, as proposed by one commenter.[1740] Such an alternative would lower the scope of entities and transactions affected by the pay to play prohibitions. As discussed in earlier sections and discussed in the economic baseline, approximately 98% of special entities rely on investment advisers in their CDS transactions. While we do not have data or information allowing us to conclude whether these investment advisers would be considered independent qualified representatives under our final rules, this alternative has the potential to substantially reduce the scope of application of the pay to play rules. While this may reduce direct and indirect costs of pay to play rules for SBS Dealers, this may also reduce their benefits, if qualified independent advisor representation does not fully resolve conflicts of interest related to prohibited political contributions by SBS Dealers and covered associates.

Finally, we have considered the alternative of increasing or decreasing the number of exemptions for inadvertent violations. The ability of SBS Dealers to cure reduces the risk that some SBS Dealers may trigger a two-year timeout as a result of inadvertent violations due to prohibited contributions by covered associates, related losses, and potential adverse effects on competition and market liquidity. At the same time, increasing the number of automatic exceptions available to SBS Dealers decreases their incentives to monitor their and their covered associates' political contributions, and may

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[1740] See SIFMA(August 2011), supra note 5.

facilitate ongoing pay to play practices. We also note that, under the rules being adopted, in addition to such automatic exceptions, SBS Dealers would be able to apply with the Commission for exemptive relief.

We do not have data or any other information concerning the sizes, donors and recipients of political contributions of entities that may trigger SBS Dealer registration and covered associates. No such information is publicly available, and commenters did not provide data enabling such quantification. Therefore, we cannot quantify the magnitude of the above effects.

8. Scope

a. Inter-Affiliate Transactions

The final business conduct rules are designed to facilitate counterparty protections, reduce information asymmetries, and enable Commission oversight. However, as discussed in Sections V and VI above, these final rules impose direct and indirect compliance costs, and may erode SBS Entities' profitability of dealing in security-based swaps, which may reduce the incentive for dealers to intermediate SBS transactions and provide liquidity to end users. We recognize, however, that some market participants, such as complex and diversified corporations or institutions, may in the regular course of business enter into inter-affiliate security-based swaps to manage risk inside a corporate group or to transfer risk to a treasury department or central affiliate.

When the economic interests of those affiliates are aligned adequately, as would be found in the case of majority-ownership, such security-based swaps serve to allocate or transfer risks within an affiliated group, rather than to move those risks out of the

group to an unaffiliated third party. Therefore, the application of these final business conduct rules to security-based swaps that SBS Entities enter into with majority-owned affiliates is unlikely to yield enhanced counterparty protections as discussed above. At the same time, SBS Entities would incur costs related to compliance with these final rules for such transactions. Therefore, the exclusion of such transactions may avoid costs that are less likely to be offset by the economic benefits considered above. Further, the CFTC excludes such swaps from substantive business conduct requirements for Swap Entities. Imposing these rules with respect to such security-based swaps would increase the relative costs of transacting in security-based swap markets, including single-name CDS, and swap markets, including index CDS. Such an approach may fragment an otherwise integrated market and could lead to a flight of liquidity to swap markets, with follow on effects on market liquidity and price discovery. As indicated earlier, Rule 15Fh-1(a) specifies that security-based swaps that SBS Entities enter into with the majority-owned affiliates will be excluded from Rules 15Fh-3(a) through 15Fh-3(f), 240.15Fh-4(b) and 240.15Fh-5. We note that CCO and supervision rules will continue to apply to dealers engaging in such swaps.

b. <u>Opt Out</u>

These final rules are intended to strengthen counterparty protections, reduce informational asymmetries between SBS Entities and their counterparties, and enhance Commission oversight over security-based swap markets. We recognize the inherent heterogeneity in the level of general sophistication and informedness specific to security-based swaps of various counterparties of SBS Entities, as suggested by some

commenters.[1741] The final rules do not allow counterparties of SBS Entities to opt out from some or all of the substantive business conduct requirements, such as disclosures of material characteristics, risks, conflicts of interest, incentives and clearing rights; suitability assessments or pay to play rules. As a result, more sophisticated and better informed counterparties of SBS Entities may enjoy few benefits, but may incur costs from these final rules.

The final rules reflect these competing considerations through a reliance on representations approach, and in safe harbors and alternatives, such as the institutional suitability alternative for customer-specific suitability and the independent advisor safe harbor for SBS Entities advising special entities. Further, some of the requirements, such as pre-trade disclosures of material incentives, risks and characteristics, will not apply to counterparties that are themselves SBS or Swap Entities. Yet other rules impose requirements on SBS Dealers, but not on Major SBS Participants, recognizing the central role of dealers as intermediaries in security-based swap markets. Finally, as discussed throughout the release, many of these final business conduct requirements are harmonized with CFTC and FINRA conduct rules, which do not allow counterparties to opt out of these or similar protections.

We also note that if counterparties are able to opt-out of some or all of the substantive requirements, SBS Entities may have an incentive to require opt-out of these final rules prior to transacting with their counterparties, or cease business with such counterparties. This effect is more likely to be present for SBS Entity – counterparty relationships, in which counterparties have the least bargaining power, such as less

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[1741] See, e.g., CalSTRS, supra note 5.

sophisticated counterparties that do not regularly access security-based swap markets, do not have established relationships with multiple dealers, and engage in low volumes of security-based swap activity. This may result in smaller, less sophisticated and less informed counterparties, which are ex ante most likely to benefit from the disclosures and protections in these final rules, opting out of business conduct rules or risking the loss of access to OTC security-based swaps if opt out was permitted. However, we recognize that the ability of counterparties to opt out of these final rules would give such entities greater flexibility in structuring their relationships with SBS Entities relative to the approach being adopted, and allow them to trade off the benefits of counterparty protections and information benefits of these final rules against potentially greater costs and lower liquidity in SBS Entity intermediated OTC security-based swaps under these final business conduct standards.

Finally, these economic considerations are attenuated by the fact that many of the final rules are not applicable to if the SBS Entity does not know the identity of the counterparty at a reasonably sufficient time prior to the execution of the transaction to permit the SBS Entity to comply with the obligations of the rule and, in certain instances, the transaction is executed on a registered national exchange or a registered or exempt SEF.

9. Cross-Border Application

As the Commission has indicated in other releases,[1742] security-based swap markets are global, and market data presented in the economic baseline demonstrates

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[1742] See, e.g., Cross-Border Adopting Release, 79 FR at 47280, supra note 684; U.S. Activity Proposing Release, 80 FR at 27454

extensive cross-border participation in security-based swap markets. For instance, Figure 1 shows that, based on DTCC-TIW data for 2014, approximately half of all new accounts participating in the market are accounts with a domicile outside the U.S. Viewed from the perspective of the domiciles of the counterparties booking credit default swap ("CDS") transactions, approximately 48 percent of price forming North American corporate single-name CDS transactions from January 2008 to December 2014 were cross-border transactions between a U.S.-domiciled counterparty and a foreign-domiciled counterparty, and an additional 40 percent of such CDS transactions were between two foreign-domiciled counterparties (see Figure 3). Thus, only 12 percent of the global transaction volume by notional volume between 2008 and 2014 was between two U.S.-domiciled counterparties, using registered office location of the TIW accounts to identify domiciles. Together, these data indicate that cross-border transactions are a common feature of dealing activity in the security-based swap market.

Further, SBS Dealers and other counterparties are highly interconnected, with most dealers transacting with hundreds of counterparties, and most non-dealers transacting with several dealers.[1743] The global scale of the security-based swap market allows counterparties to access liquidity across jurisdictional boundaries, providing market participants with opportunities to share these risks with counterparties around the world. Because dealers facilitate the great majority of security-based swap transactions, with bilateral relationships that extend to potentially thousands of counterparties,

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[1743] Based on an analysis of 2014 DTCC-TIW transaction data, accounts likely to register with the Commission as SBS Dealers have on average 759 unique counterparties (a median of 453 unique counterparties). All other accounts (i.e., those more likely to belong to non-dealers) averaged four unique counterparties (a median of three counterparties).

deficiencies in SBS Dealer disclosures, recommendations of unsuitable security-based swaps, and informational asymmetries may affect a large number of counterparties and have potentially significant cross-border implications.

a. Scope of Application to SBS Entities

As discussed in Section III, business conduct requirements fall into two categories: entity-level business conduct requirements, such as CCO rules and supervision, and transaction-level requirements, such as disclosure and suitability. The final rules create certain exceptions from application of the transaction-level business conduct requirements to registered SBS Dealers and Major SBS Participants in certain transactions. With respect to SBS Dealers, these transaction-level requirements will apply to any transaction that constitutes an SBS Dealer's U.S. business but not to any transaction that constitutes its foreign business. For U.S. SBS Dealers, U.S. business includes all of their transactions, except for certain transactions conducted through a foreign branch. For foreign SBS Dealers, U.S. business includes all of their transactions with U.S. persons (except for certain transactions conducted through a foreign branch of a U.S.-person counterparty) and transactions captured by the U.S. Activity Test (i.e., transactions with another non-U.S. person that the foreign SBS Dealer arranges, negotiates, or executes using personnel located in a U.S. branch or office).

The final rule creates a slightly different exception for Major SBS Participants. U.S. Major SBS Participants must comply with the business conduct requirements in all their transactions, except for certain transactions conducted through a foreign branch, and foreign Major SBS Participants must comply with the requirements in their transactions with U.S. persons, except for certain transactions conducted through a foreign branch.

Under the final rule, the exception for foreign Major SBS Participants does not incorporate a U.S. Activity Test.

In considering the economic effects of this cross-border approach, we recognize that the economic baseline reflects markets as they exist today, in which compliance with business conduct standards for security-based swaps is not required. Therefore, these final business conduct rules will apply with respect to security-based swap transactions intermediated by SBS Entities where they currently do not. Under Exchange Act Section 15F, these requirements apply to registered SBS Entities by virtue of their registration with the Commission and, in the absence of any exceptions to the requirements, would apply to all business of a registered SBS Entity. However, final Exchange Act rules 3a71-3(c) and 3a67-10(d) create certain exceptions, as described above, that limit the application of these requirements to a subset of the transactions of a registered SBS Entity. For example, a foreign SBS Dealer transacting with a foreign counterparty will not be subject to Title VII transaction-level business conduct requirements if the foreign SBS Dealer does not rely on personnel located in the United States to arrange, negotiate or execute the swap, including with respect to transactions in which the foreign SBS Dealer's counterparty may have relied on personnel located in the United States.

However, we recognize that the inclusion of the U.S. Activity Test in the definition of "U.S. business" for foreign dealers may increase the set of transactions that will be required to comply with these final business conduct rules, relative to the alternative under which foreign dealers transacting with foreign counterparties are not subject to these final rules. We also recognize that capturing transactions of foreign SBS

Entities with U.S. persons may increase the set of transactions subject to the final business conduct rules as compared to the alternative of not capturing such transactions.

The final cross-border approach to the scope of the final business conduct requirements may produce several benefits. First, classifying certain rules, such as diligent supervision and CCO rules, as entity-level requirements that apply to the entire security-based swap business of the registered SBS Entity may facilitate Commission oversight of registered SBS Entities and enhance compliance with federal securities laws and Commission rules. For example, as discussed in Section III and in the Cross-Border Proposing Release, supervision and CCO rules are aimed at mitigating conflicts of interest and enhancing compliance with securities laws, rules and regulations thereunder by the entire registered SBS Entity. The Commission continues to recognize that relevant conflicts of interest and non-compliance may arise as a result of transactions comprising an SBS Entity's foreign business. Further, we note that CCO duties include establishing, maintaining, and reviewing policies and procedures reasonably designed to ensure compliance with applicable Exchange Act requirements that apply to the SBS Entity as a whole. As discussed in Section III, the Commission is applying diligent supervision and CCO duties rules at the entity level.

Second, by imposing transaction-level requirements on transactions of SBS Entities with U.S.-person counterparties, subject to a tailored foreign branch exception, these final rules result in disclosure, suitability, fair and balanced communications and special entity requirements, among others, applying to transactions that are particularly likely to raise the types of counterparty protection and other concerns addressed by Title VII business conduct requirements, whether carried out by U.S. or foreign SBS Entities.

Specifically, this approach to security-based swap transactions between registered SBS Entities and U.S. persons may potentially enhance the expected counterparty protection, reduce information asymmetry, and facilitate Commission oversight benefits of these final rules to the U.S. security-based swap market.

Third, requiring registered foreign SBS Dealers (but not Major SBS Participants) to comply with business conduct requirements with respect to any transaction with another non-U.S.-person counterparty that the foreign SBS Dealer arranges, negotiates, or executes using personnel located in the United States will facilitate more uniform regulatory treatment of the security-based swap activity of registered SBS Dealers operating in the United States, mitigating potential competitive distortions.[1744] Although applying other business conduct frameworks (such as broker-dealer regulation) to this activity may achieve similar regulatory goals, the availability of exceptions, exclusions and safe harbors may mean that alternative frameworks may not apply to certain business structures used by registered SBS Dealers to carry out their business in the United

[1744] We recognize that, depending on the business structure that a registered U.S. or foreign SBS Dealer employs, an intermediary (such as an agent that is a registered broker-dealer) may already be subject to certain business conduct requirements with respect to the SBS Dealer's counterparty in the transaction. However, we continue to believe that it may be important that registered SBS Dealers themselves are subject to these final business conduct requirements with respect to security-based swap transactions that are part of their U.S. business. Because SBS Dealers and their agents may allocate between themselves specific responsibilities in connection with these business conduct requirements, to the extent that these requirements overlap with requirements applicable directly to the agent (for example, in its capacity as a broker), and the SBS Dealer allocates responsibility for complying with relevant requirements to its agent, we expect any increase in costs arising from the proposed rules may be mitigated.

States.[1745] Moreover, these alternative frameworks may apply only to the U.S. intermediary of the foreign SBS Dealer and not to the SBS Dealer itself. These final rules will avoid these differences in application, along with the potential competitive disparities they may create, by subjecting all registered SBS Dealers engaged in transactions captured by the U.S. Activity test to the same business conduct framework, including, among others, disclosure, suitability, and fair and balanced communication rules. Applying business conduct rules to all security-based swap trades arranged, negotiated or executed by personnel located in the U.S. also may reduce disparities between U.S. and foreign SBS Dealers competing for business with the same foreign counterparties.

We recognize that foreign SBS Dealers transacting with foreign counterparties may be subject to foreign regulations in addition to these final rules, giving rise to potentially duplicative compliance costs, pointed out by commenters.[1746] However, as discussed in Section III above, the Commission believes that requiring registered foreign SBS Dealers to comply with the transaction-level business conduct requirements with respect to these transactions may enhance transparency, strengthen counterparty protections, and integrity of the U.S. security-based swap market.

Moreover, the Commission is adopting a framework that would potentially permit foreign SBS Dealers to satisfy their requirements with respect to certain of the business conduct requirements by complying with comparable requirements of a foreign

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1745 For example, Exchange Act section 3(a)(4)(B) excepts banks from the definition of "broker" with respect to certain activity.

1746 See, e.g., IIB (July 2015), supra note 10; ISDA (July 2015), supra note 10; SIFMA-AMG (July 2015), supra note 10; SIFMA/FSR (July 2015), supra note 10, commenting on the U.S. Activity Proposing Release.

jurisdiction. Therefore, foreign SBS Dealers engaged in U.S. Activity may be able to comply with these final rules by complying with foreign jurisdictions' rules and regulations, to the extent that the Commission makes substituted compliance determinations and the other prerequisites to substituted compliance have been satisfied. This may mitigate the potential for conflicting requirements and duplication in compliance costs. We recognize that there will be limits to the availability of substituted compliance, including the possibility that substituted compliance may be permitted with regard to some requirements and not others, or that, in certain circumstances, substituted compliance may not be permitted with respect to any requirements with regard to a particular jurisdiction depending on our assessment of the comparability of the relevant foreign requirements and the availability of supervisory and enforcement arrangements among the Commission and relevant foreign financial regulatory authorities. However, the Commission does not believe it would be appropriate to permit foreign security-based swap dealers to satisfy these final business conduct requirements by complying with foreign requirements when the prerequisites to substituted compliance have not been satisfied.[1747]

As we noted earlier, these rules limit the scope of application of these final business conduct requirements by excluding certain transactions of registered foreign and U.S. SBS Entities from the requirements. However, as we have also noted, relative to the baseline, final Exchange Act rules 3a71-3(c) and 3a67-10(d), together with the substantive rules being adopted in this release, should result in an increase in costs and benefits from the baseline. Specifically, the final approach to cross-border application of

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[1747] See Section III, supra.

the final business conduct rules may increase assessment and programmatic costs of registered SBS Dealers, but may also increase related counterparty protections, reduce informational asymmetries and enhance Commission oversight.

With respect to assessment costs, registered SBS Entities likely will establish systems to identify transactions that are subject to the business conduct requirements. Foreign SBS Entities will need to establish systems to identify transactions with U.S. persons (including whether the transaction is conducted through a foreign branch of that person), and foreign SBS Dealers will need to establish systems to identify transactions falling within the U.S. Activity Test. Similarly, U.S. SBS Entities will incur additional assessment costs related to identifying their own transactions conducted through a foreign branch, including such transactions with U.S.-person counterparties that constitute transactions conducted through a foreign branch of those U.S.-person counterparties. Most of the assessment costs with respect to analysis and systems to track transactions have been evaluated in connection with other Commission rules; therefore, our economic baseline includes all registered SBS Entities have those systems in place. For instance, in the Cross-Border Adopting Release, the Commission estimated foreign SBS Entity assessment costs with respect to systems tracking transactions with U.S. persons for purposes of counting transactions toward the major security-based swap participant position thresholds and the security-based swap dealer de minimis thresholds.[1748]

[1748] See Cross-Border Adopting Release, 79 FR 47332-34 (evaluating foreign SBS Dealer assessment costs with respect to systems tracking transactions with U.S. persons); id. at 47353-54 (evaluating foreign Major SBS Participant assessment costs with respect to systems tracking transactions with U.S. persons). In that release, the foreign branch exception applied only to U.S. banks that were themselves registered SBS Dealers, and our evaluation of analysis costs borne by

Similarly, in the U.S. Activity Adopting Release, the Commission evaluated the assessment costs to SBS Dealers related to including transactions falling within the U.S. Activity Test in a non-U.S. person's dealer de minimis requirements.[1749] Once registered, these SBS Entities will be able to use these systems in connection with identifying whether a transaction is subject to the transaction-level business conduct requirements.`

However, in addition to these previously evaluated costs, U.S. SBS Entities conducting business through a foreign branch will need to classify their counterparties and transactions to determine whether business conduct transaction-level requirements apply. We believe that the costs to a U.S. SBS Entity of creating systems to identify transactions it conducts through a foreign branch with U.S.-person counterparties and to determine whether any such transactions are conducted through the foreign branch of its U.S.-person counterparties may be similar to costs associated with the systems that foreign persons are likely to establish to perform the dealer de minimis or major participant threshold calculations. In both cases such systems would have to flag a person's security-based swaps against the specific criteria embedded in the final rules. Based on the methodology set out in the Cross-Border Adopting Release for estimating costs of

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such persons were based on a system that would evaluate whether a counterparty was a U.S. person, whether that counterparty was transacting through a foreign branch, and whether that counterparty was a registered SBS Dealer, among other things. See, e.g., Cross-Border Adopting Release, 79 FR 47353. Because the analysis to determine whether the transaction-level business conduct requirements apply in a transaction by a foreign SBS Entity with a U.S. person involve only a determination whether the counterparty is a U.S. person and whether it is transacting through a foreign branch, we believe that the system whose costs were estimated in these prior releases should be sufficient for the analysis required by foreign SBS Entities under these rules.

[1749] See U.S. Activity Adopting Release, 81 FR 8627 (evaluating assessment costs to SBS Dealers with respect to systems for tracking transactions arising from U.S. activity).

systems designed to identify similar criteria,[1750] we estimate these assessment costs may include one-time programming costs of $14,904 and ongoing annual costs of $16,612 per SBS Entity.[1751] Based on a review of DTCC–TIW data relating to single-name CDS activity in 2014, we estimate that up to 5 U.S. SBS Dealers conducted dealing activity

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1750 See Cross-Border Adopting Release, 79 FR 47332, note 681. See also Definitions Adopting Release, 77 FR 30734–35, note 107.

1751 In the Definitions Adopting Release, we estimated that the one-time programming costs of $13,692 per entity and annual ongoing assessment costs of $15,268. See Definitions Adopting Release, 77 FR 30734–35, and accompanying text (providing an explanation of the methodology used to estimate these costs). The hourly cost figures in the Definitions Adopting Release for the positions of Compliance Attorney, Compliance Manager, Programmer Analyst, and Senior Internal Auditor were based on data from SIFMA's Management & Professional Earnings in the Securities Industry 2010.

For purposes of the cost estimates in this release, we have updated these figures with more recent data as follows: the figure for a Compliance Attorney is $334/hour, the figure for a Compliance Manager is $283/hour, the figure for a Programmer Analyst is $220/hour, and the figure for a Senior Internal Auditor is $209/hour, each from SIFMA's Management & Professional Earnings in the Securities Industry 2013, modified by SEC staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. We also have updated the Definitions Adopting Release's $464/ hour figure for a Chief Financial Officer, which was based on 2011 data, with a revised figure of $500/ hour, for a Chief Financial Officer with five years of experience in New York, that is from http://www.payscale.com, modified by Commission staff to account for an 1800-hour work-year and multiplied by 5.35 to account for bonuses, firm size, employee benefits, and overhead. See http://www.payscale.com (last visited Apr. 16, 2014).

Incorporating these new cost figures, the updated one-time programming costs based upon our assumptions regarding the number of hours required in the Definitions Adopting Release would be $14,904per entity, i.e., (Compliance Attorney at $334 per hour for 2 hours) + (Compliance Manager at $283 per hour for 8 hours) + (Programmer Analyst at $220 per hour for 40 hours) + (Senior Internal Auditor at $209 per hour for 8 hours) + (Chief Financial Officer at $500 per hour for 3 hours) = $14,904, and the annual ongoing costs would be $16,612 per entity, i.e., ((Senior Internal Auditor at $209 per hour for 16 hours) + Compliance Attorney at $334 per hour for 4 hours) + (Compliance Manager at $283 per hour for 4 hours) + (Chief Financial Officer at $500 per hour for 4 hours) + (Programmer Analyst at $220 per hour for 40 hours) = $16,612).

through foreign branches, and we conservatively estimate that there may be as many as 5 U.S. Major SBS Participants. Assuming that all ten of these U.S. SBS Entities elected to establish a system to identify transactions conducted through a foreign branch or conducted through the foreign branch of their U.S. counterparties, the total assessment costs associated with our final business conduct rules would be approximately $149,040 in one-time annual programming costs and $166,120 in ongoing annual costs.[1752]

As recognized in Section III above, SBS Entities would be permitted to rely on certain representations provided to them by their U.S. bank counterparties regarding whether a transaction is conducted through a foreign branch. Initial costs to the U.S. bank counterparties of developing related representations are estimated at $195,000.[1753] Aggregate ongoing costs to the U.S. bank counterparties of representations are estimated at approximately $190,000 per year.[1754]

This scope of transactions subject to business conduct requirements may also affect the programmatic costs incurred by participants in security-based swap markets. For entities already required to register as SBS Entities under current rules, this rule may increase the set of transactions and counterparties to which they must apply business conduct requirements, relative to the baseline under which no business conduct requirements apply. We continue to recognize that requiring compliance of foreign SBS Dealers transacting with foreign counterparties where transactions were arranged,

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1752 One-time annual programming cost: $14,904 x 10 U.S. SBS Entities = $149,040. Ongoing annual cost: $16,612 x 10 U.S. SBS Entities= $166,120.

1753 Initial cost: Outside counsel $100,000 + ((Attorney at $380 per hour) x 250 hours = $95,000) = $195,000.

1754 Ongoing cost: (In-house attorney at $380 per hour) x 500 hours = $190,000.

negotiated or executed by personnel located in the United States may discourage reliance by foreign SBS Entities on personnel located in the United States. Some foreign SBS Dealers transacting with foreign counterparties may choose to relocate their personnel outside of the United States, or replace personnel located in the United States with personnel not located in the United States to avoid compliance with these final rules. To the extent that these final rules may increase the costs of foreign SBS Entities, or influence competition between U.S. and foreign SBS Dealers, the terms of security-based swaps intermediated by foreign SBS Dealers may deteriorate and foreign SBS Dealers may become less willing to intermediate security-based swap transactions. The approach taken in this rule may mitigate some of the commenter concerns with the initial proposal by focusing only on the location of the foreign dealer's or its agent's market-facing personnel, and not the location of its counterparties' activity.[1755] Further, these final rules allow for the possibility of substituted compliance for foreign SBS Dealers, including in connection with their security-based swap activity with foreign counterparties. Therefore, as discussed above, these costs may be incurred primarily by foreign SBS Entities subject to less stringent business conduct rules in their foreign jurisdictions, where the ex-ante benefits of these final rules may be greater.[1756]

The Commission has received comment that this approach to the application of business conduct requirements may impose costs of additional disclosures and representations on asset managers servicing foreign clients.[1757] As we noted in Section

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[1755] See U.S. Activity Adopting Release, 81 FR 8634.

[1756] See, e.g., SIFMA-AMG (July 2015) supra note 10 and ISDA (July 2015), supra note 10, on the U.S. Activity Proposing Release.

[1757] See SIFMA-AMG (July 2015), supra note 10, at 4.

III, these final rules do not apply directly to asset managers, and asset managers will incur no liability under these rules. However, we recognize that SBS Entities may have certain expectations of asset managers in connection with the transactions involving funds. Depending on how SBS Entities and asset managers choose to allocate these responsibilities, asset managers may incur some fraction of the costs estimated above. The commenter also argued that the final rules may result in asset managers separating block trades for U.S. and non-U.S. persons, for whom business conduct eligibility has not been verified, and obtaining assurances that the dealer's personnel arranging, negotiating or executing block trades for non-U.S. persons is not based in the U.S. We recognize that, to the extent this affects the ability of asset managers to find counterparties to block trades with non-U.S. persons or the costs of doing so, liquidity may become fragmented and execution price of certain block trades may be adversely affected. We note that some asset managers may be complying with similar requirements, such as those under the Exchange Act and FINRA rules applicable to U.S. broker-dealers related to transactions in cash securities that these broker-dealers intermediate on behalf of foreign brokers.

We have considered the alternative of applying business conduct rules to all security-based swap transactions of all registered SBS Entities. This approach would increase the scope of transactions subject to these substantive rules, increasing programmatic costs of compliance by registered SBS Entities – costs that are likely to be passed on to counterparties. Under the rules being adopted, the U.S. business of foreign SBS Dealers excludes transactions conducted through a foreign branch. Further, the final rule provides for an exception from the transaction-level business conduct requirements when a foreign Major SBS Participant (or a U.S. Major SBS Participant in a transaction

conducted through its foreign branch) enters into a transaction with a foreign branch of a U.S. person.

To the extent that potential losses on security-based swap transactions may flow from foreign branches of U.S. persons to the U.S. business of U.S. persons, excluding transactions of foreign SBS Dealers with foreign branches of U.S. persons from the definition of U.S. business may increase risks to U.S. persons and impact the integrity of U.S. markets. However, compliance with business conduct requirements with respect to security-based swap transactions between foreign SBS Entities and foreign branches of U.S. persons would further increase costs of foreign SBS Entities. Such costs may be passed along to foreign branches of U.S. persons in the form of higher transaction costs or reduced access to security-based swap transactions with foreign SBS Entities.[1758] We lack data regarding the reliance of U.S. persons on foreign branches for their security-based swap activity with foreign SBS Dealers, current business conduct practices of foreign SBS Dealers in their relationships with foreign branches of U.S. persons, and the value of bilateral relationships for this group of market participants. Therefore, we are unable to quantify these effects. However, the approach being adopted recognizes these competing risk and access considerations.

The Commission has also considered the alternative of applying these final business conduct rules to all transactions that a U.S. SBS Entity enters into, including any transaction conducted through its foreign branch. Importantly, the definition of "transactions conducted through a foreign branch" requires the transaction to be arranged,

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[1758] See Cross-Border Adopting Release, 79 FR at 47343, supra note 684.

negotiated or executed in the foreign branch.[1759] The activities of foreign branches of U.S. SBS Dealers relying on foreign personnel transacting with foreign counterparties may not pose the same compliance and counterparty risks in U.S. markets as those addressed by these final business conduct requirements. As a result, this alternative may produce fewer intended benefits associated with these final rules, but would increase costs of U.S. SBS Dealers transacting with foreign counterparties.

The Commission has also considered the alternative of excepting all transactions of a foreign SBS Dealer with non-U.S. persons, including transactions that involve U.S. activity. We recognize that the alternative would decrease the set of transactions subject to the final business conduct rules, reducing both assessment and programmatic costs to foreign SBS Dealers, and expected programmatic benefits of these final rules discussed above. Data on North American corporate single name CDS market in Figure 3 of the economic baseline suggest that activity among non-U.S. domiciled accounts represents as much as 17% (if we use the domicile of a corporate group) to 40% (if we use registered office location) of global notional volume, and potentially a larger percentage if firms restructure their business in response to such an exception. We do not currently have data on which of those trades are arranged, negotiated or executed by U.S. personnel of foreign SBS Dealers. However, we note that the U.S. Activity Test in these final rules will subject some foreign SBS Dealer transactions with foreign counterparties to these business conduct rules. Therefore, this alternative would reduce the scope of activity subject to the transaction-level requirements of these final rules, and their resulting costs and benefits, relative to the approach being adopted.

[1759] See Exchange Act Rule 3a71-3(a)(3).

In addition, this alternative could put U.S. SBS Entities at a competitive disadvantage due to higher direct and indirect costs related to these final business conduct rules when dealing with foreign counterparties. This approach may also incentivize U.S. SBS Dealers to restructure to be considered a non-U.S. person, while continuing to rely on personnel located in the United States to negotiate, arrange or execute security-based swap transactions with their foreign counterparties. As recognized above, we understand security-based swap markets to be global, and we expect registered SBS Dealers transact across multiple jurisdictions. This alternative may involve potentially significant frictions to cross-border transaction activity and may lead to fractioned liquidity and participation in otherwise globally integrated markets. The approach being adopted may reduce incentives to engage in such restructuring by requiring that foreign SBS Dealers comply with transactional business conduct requirements even when transacting with another non-U.S. person where such security-based swap transactions are arranged, negotiated or executed by personnel located in the United States.

Finally, we have considered an alternative approach that would limit the scope of application of these final business conduct rules to transactions between registered SBS Entities and U.S. person counterparties. This alternative would exclude transactions between U.S. as well as non-U.S. SBS Dealers and their foreign counterparties, which may significantly decrease the scope of application and potential economic effects of these final rules.

First, excluding transactions between U.S. SBS Dealers and their foreign counterparties from the scope of these requirements may reduce direct and indirect compliance costs of U.S. SBS Dealers, potentially reducing transaction costs or

improving liquidity; however, it may reduce potential information benefits of these final rules. Second, similar to the discussion above, excluding transactions between foreign SBS Dealers and their foreign counterparties may mitigate incentives for inefficient relocation by financial groups that use a non-U.S. dealer to carry out their dealing activity in the United States.

However, to the extent compliance with these business conduct requirements is costly and these costs are passed along to counterparties in, for instance, more adverse pricing and lower liquidity of available OTC security-based swaps, this alternative may give rise to competitive disparities between U.S. and non-U.S. counterparties of registered SBS Dealers. U.S. counterparties that are members of financial groups may respond by restructuring their security-based swap activity so that it is carried out by a non-U.S. person, in which case none of its transactions with SBS Dealers would be required to comply with transaction level business conduct requirements and incur related costs. To the extent that counterparties restructure their security-based swap activity in response to the incentives created by the competitive disparities and market fragmentation, a significant portion of that activity may occur outside the scope of these final business conduct requirements. U.S. persons that currently transact with SBS Dealers may have an incentive to migrate that business to affiliated non-U.S. persons to stay competitive with their non-U.S. competitors. The fraction of U.S. counterparties able to perform such restructuring and related costs are unclear. In contrast, the approach being adopted recognizes the importance of SBS Entity conduct for counterparty protections, may decrease incentives for such evasion, and enhance Commission oversight of registered SBS Entities.

b. Substituted Compliance

As discussed in Section III, the final rules contemplate a substituted compliance regime for substantive business conduct requirements. Substituted compliance may permit the counterparty protection, information and Commission oversight benefits of these final business conduct rules to be achieved while avoiding potential duplication of compliance costs that foreign SBS Entities may otherwise incur. As indicated in the Cross-Border release,[1760] to the extent that our business conduct rules conflict with regulations in foreign jurisdictions that also govern the activity of foreign SBS Entities that are subject to Title VII business conduct requirements, these final rules could act as a barrier to entry for foreign SBS Entities into the U.S. security-based swap market. Allowing market participants to comply with these final business conduct rules via substituted compliance could facilitate participation of non-resident SBS Entities in U.S. security-based swap markets. If foreign regulatory regimes are comparable to these final rules requirements,[1761] and to the extent that such foreign regimes have adequate compliance and enforcement capabilities, allowing substituted compliance for nonresident SBS Entities may help promote market efficiency and enhance competition in U.S. markets, potentially benefiting non-dealer counterparties.

At the same time, the process of making substituted compliance requests may cause nonresident SBS Entities to incur additional costs of applying for a substituted compliance determination. In Section V the Commission has estimated that three security-based swap dealers will submit substituted compliance applications, noting that

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[1760] See Cross-Border Adopting Release, 79 FR at 47359, supra note 684.

[1761] See ISDA (August 2013), supra note 7.

the majority of substituted compliance requests may be made by foreign authorities. Based on our analysis of domiciles of likely SBS Entity registrants and our understanding of the market, we believe that there may be between four and nine substituted compliance applications with respect to these final rules. The total cost associated with SBS Entities preparing and submitting requests for substituted compliance determinations in connection with the business conduct requirements are estimated at, approximately, $406,770 [1762] for up to three requests. We also estimate that up to six foreign jurisdictions may make substituted compliance requests in connection with these final business conduct standards at an estimated cost of up to $524,790.[1763]

1762 Initial internal cost of substituted compliance applications for SBS Entity applicants: (In-house attorney at $380 per hour) x (80 hours) x3 = $91,200. External: (External counsel at 400$ per hour) x 200x3 = $240,000.

Consistent with the Registration Adopting release, certification and opinion of counsel is estimated at: a) (In-house attorney at $380 per hour) x 0.5 hours x 3 = $570. b) External: (External counsel at 400$ per hour) x 62.5x3 = $75,000. See Registration Adopting Release, 80 FR at 48994

Total cost for SBS Entities: $240,000+$75,000+$91,200+$570=$406,770

As noted in Section V, those amounts may overestimate the costs of requests pursuant to Rule 3a71-6 as adopted, as such requests would solely address business conduct requirements, rather than the broader proposed scope of substituted compliance set forth in that proposal. In addition, some SBS Entities may receive a positive substituted compliance determination and use the same certification and opinion of counsel when filing for registration, the costs of which were assessed in the Registration Adopting Release.

1763 We believe that foreign jurisdictions are less likely to rely on outside counsel in preparing substituted compliance determinations and adequate assurances concerning Rule 15Fb2-4(c). In lieu of outside counsel we believe they will rely on internal government attorneys, estimated using SEC hourly cost for management and professional staff of $255.

Initial cost of substituted compliance applications for up to 6 foreign jurisdiction: (Government management and professional staff at $255) x (80 + 200) x 6= $428,400.

We note that substituted compliance requests will be made on a voluntary basis, and nonresident SBS Entities would only make such requests when the anticipated costs of relying on substituted compliance are lower than the costs of complying directly with these final rules. Further, after a substituted compliance determination is made, SBS Entities would choose substituted compliance only if their expected private benefits from participating in U.S. security-based swap markets exceed expected private costs, including any conditions the Commission may attach to the substituted compliance determination.

We also recognize that these costs and the overall economic effects of allowing substituted compliance for these final business conduct rules will depend on, among others, whether (and to what extent) substituted compliance requests will be granted for jurisdictions in which some of the most active nonresident SBS Entities are currently residing; the costs of potential relocation, business restructuring, or direct compliance by nonresident SBS Entities in jurisdictions for which substituted compliance is not granted; the relevant information required to demonstrate consistency between the foreign regulatory requirements and the Commission's business conduct rules; the relevant information required to demonstrate the adequacy of the foreign regime's compliance and enforcement mechanisms; and the fraction of SBS Entities in a given jurisdiction that may rely on substituted compliance if available.

Initial cost of certifications and assurances concerning Rule 15Fb2-4(c): (Government management and professional staff at $255) x (0.5+62.5) x 6= $96,390

Total cost for foreign jurisdictions: $428,400 +$96,390=$524,790

We note that substituted compliance determinations will be made on a jurisdiction-wide basis. As a result, after the first applicant from a given jurisdiction receives an affirmative substituted compliance determination, all SBS Entities from the same jurisdiction will be able to comply with these final rules by complying with requirements of that foreign jurisdiction without bearing the related substituted compliance application costs. Such an approach eliminates duplication in application costs for SBS Entities from the same jurisdictions. However, foreign SBS Entities that are the first to make a substituted compliance application from a given jurisdiction will also bear greater costs, which disadvantages first movers. SBS Entities that intermediate greater volume or hold larger positions of security-based swaps in the United States, and SBS Entities that face greater costs of direct compliance with these final rules compared to costs of compliance with rules of a foreign jurisdiction may be the first SBS Entities to make substituted compliance applications and bear application costs.

SBS Entities in foreign jurisdictions with blocking laws, privacy laws, secrecy laws and other legal barriers inconsistent with the Commission's authority over registered entities will be unable to take advantage of substituted compliance. As part of these final rules, the Commission is adopting a requirement that, in order to make a request for substituted compliance, each party must provide the certification and opinion of counsel that the entity can as a matter of law, and will, provide the Commission with prompt access to the entity's books and records and submit to onsite inspection and examination by the Commission. Similarly, foreign financial regulatory authorities may make substituted compliance requests only if they can provide adequate assurances that no law or policy of any relevant foreign jurisdiction would impede the ability of any entity that is

directly supervised by the authority and that may register as an SBS Entity to provide prompt access to the Commission to books and records or to submit to onsite inspection or examination. As a result of these requirements, the scope of SBS Entities and jurisdictions able to take advantage of substituted compliance may be reduced. However, as we have stated elsewhere,[1764] the Commission believes that significant elements of an effective regulatory regime are the Commission's abilities to access registered SBS Entities' books and records and to inspect and examine the operations of registered SBS Entities.

We note that U.S. SBS Entities will not be able to rely on substituted compliance with respect to any transactions, including transactions with foreign counterparties. Alternatively, the Commission could allow substituted compliance for U.S. SBS Entities. Under the alternative, U.S. SBS Entities would be able to comply with these substantive transaction-level requirements by complying with business conduct requirements of a comparable regulatory regime when dealing with counterparties domiciled in foreign countries. We recognize that U.S. SBS Entities may be competing for foreign counterparty business with foreign SBS Entities, and substituted compliance may reduce costs of complying with these final business conduct requirements. Under the alternative, the ability of U.S. SBS Entities to rely on substituted compliance may increase the profitability of U.S. SBS Entities transactions with foreign counterparties or may increase business for U.S. SBS Entities seeking to intermediate security-based swaps with foreign market participants. However, such an approach may adversely impact counterparty protection, informational asymmetry and Commission oversight benefits of these

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[1764] See Registration Adopting Release, 80 FR at 48981

substantive requirements enjoyed by all counterparties of U.S. SBS Entities as a result of potential differences among global regulatory regimes. Since any potential costs of compliance with these substantive requirements may be passed on to counterparties, such an alternative may result in differential access and security-based swap terms of U.S. and foreign counterparties of U.S. SBS Entities.

Under the approach being adopted, foreign SBS Entities will be able to comply with these final business conduct requirements by complying with comparable foreign requirements. We have considered an alternative approach, under which the availability of substituted compliance is predicated on a finding of a direct conflict between Title VII and foreign regulatory requirements. Under this alternative, foreign SBS Entities that are currently complying with comparable (though not identical) requirements, would be required to bring their activities into compliance with these final rules, absent a direct conflict between Title VII requirements and their foreign regulatory regime. If the scope of comparable regulatory regimes is broader than the scope of regimes that are in direct conflict with the requirements of Title VII, this alternative may enable SBS Entities from fewer jurisdictions to take advantage of substituted compliance. As a result, the economic benefits of substituted compliance discussed above may be reduced.

Fewer foreign SBS Entities being eligible for substituted compliance may also reduce direct application costs to the industry. However, the burden of establishing a direct conflict may be greater than the burden related to establishing comparability, which may increase direct substituted compliance costs per application.

Crucially, if fewer SBS Entities are able to take advantage of substituted compliance under this alternative, a greater number of foreign SBS Entities would be

required to incur costs of restructuring their systems and processes to comply with these final rules. Alternatively, foreign SBS Entities may choose relocate to another jurisdiction, or decrease their participation in U.S. security-based swap markets below thresholds triggering SBS Entity registration requirements and compliance with these final rules. To the extent that these costs may be passed on to counterparties of foreign SBS Entities or affect liquidity provision by foreign SBS Entities, transaction costs may increase and liquidity may be reduced. Further these costs may create a barrier to entry for foreign SBS Entities into U.S. security-based swap markets, and facilitate market segmentation.

Under this alternative, counterparties of foreign SBS Entities unable to rely on substituted compliance may benefit to a greater extent from the transparency and counterparty protections of these final rules. Further, U.S. SBS Entities and foreign SBS Entities from jurisdictions that are able to rely on substituted compliance may step in to intermediate trades with counterparties impacted by foreign SBS Entities unable to rely on substituted compliance. The Commission's future substituted compliance determinations with respect to individual foreign regimes will affect the scope of affected foreign SBS Entities. Therefore, we are unable to estimate and compare the number, market share and scope of counterparties of foreign SBS Entities that may be able to rely on substituted compliance under the approach being adopted, and under the alternative. However, we note that, using DTCC-TIW data as of year-end 2014, all foreign SBS Dealers likely to trigger registration requirements were responsible for 35% of the notional volume of all likely SBS Entities. In addition, as we have noted earlier in the

economic analysis, in 2014 non-dealer counterparties transacted with a median of three and an average of four SBS Dealers.

We have also considered an alternative approach under which foreign SBS Entities would be able to rely on substituted compliance only in their transactions with non-U.S. counterparties. This alternative would effectively limit the scope of substituted compliance to non-U.S. SBS Entities that are transacting with non-U.S. counterparties, but are subject to these final rules as a result of their reliance on U.S. personnel discussed above. Such an approach could ensure that U.S. counterparties of all SBS Entities benefit from the same transparency and counterparty protection benefits of these final rules, regardless of the degree of comparability of foreign regimes. However, some foreign SBS Entities already complying with comparable regimes would incur additional costs of restructuring to comply with these final rules without being able to rely on substituted compliance in their transactions with U.S. counterparties. If such costs are significant, non-U.S. SBS Entities may become less willing to intermediate transactions with U.S. counterparties and transaction costs borne by U.S. counterparties may increase. While other U.S. SBS Entities are likely to step in and provide the necessary liquidity, this approach may adversely impact competition and facilitate market segmentation.

D. Effects on Efficiency, Competition and Capital Formation

In adopting these final rules, we are required to consider their effects on efficiency, competition and capital formation. As we discuss below, these final rules may enhance transparency, and improve informational and allocative efficiency in security-based swap markets. Greater transparency and allocative efficiency may incentivize quality based competition among market participants in general, and SBS Dealers in

particular. In the discussion below, we address the potential effects of final disclosure, suitability and special entity rules on informational and allocative efficiency, and their effects on capital formation in security-based swap and reference security markets. We also consider how harmonization with the CFTC external business conduct rules facilitates ongoing market integration between swap and security-based swap markets, and lowers informational inefficiencies. Finally, we discuss the competitive burdens of compliance costs, their effects on the willingness of SBS Dealers to intermediate transactions with certain groups of counterparties, as well as competitive effects of the cross-border approach being adopted.

The business conduct standards for SBS Entities, including requirements to disclose material risks, characteristics, incentives and conflicts of interest related to security-based swaps, as well as the fair and balanced communications rule, may reduce information asymmetries between SBS Entities and their less sophisticated counterparties. To the extent that adverse selection costs described in Section VI.C.2 are present in security-based swap markets, market participants may become more informed and may increase their activity in security-based swaps, which may improve market quality. To the extent that security-based swap market participants consider disclosures under these final rules informative in selecting security-based swaps and SBS Entity counterparties, these final rules may help market participants make more informed counterparty choices. The increased disclosure of information regarding material risks and characteristics, incentives and conflicts of interest may lead to improved informational efficiency and quality-based competition among SBS Entities to the extent

that market participants rely on this information in selecting security-based swaps and counterparties.

However, as more informed counterparties, SBS Entities are able to extract information rents from non-dealer counterparties. To the extent that the business conduct rules help inform counterparties, these rules may reduce the informational advantage of SBS Entities, and may decrease profitability of their transactions with non-dealer counterparties. As a result of disclosures of material risks, daily mark, conflicts of interest and other information regarding security-based swaps, some private information of SBS Dealers about the quality of security-based swaps and underlying reference securities may become public. As a result, security-based swap prices and dealer profit margins may decrease. These rules may reduce the incentives of SBS Dealers to gather private information that is impounded into prices, and SBS Dealer willingness to intermediate security-based swap transactions with non-dealer counterparties.

Enhanced disclosures and counterparty protections of these Business Conduct Standards may improve access to information, and may attract non-dealer market participants into security-based swap markets. These rules may, therefore, protect end users and other non-dealers that are effecting security-based swaps to manage risk or trade on negative information, which may improve their ability to make appropriate and informed portfolio decisions. However, if these rules result in less informed market participants playing an increasingly larger role in security-based swap markets, informational efficiency in security-based swap markets may decrease. This consideration is attenuated by the fact that uninformed participants bring valuable liquidity enabling informed traders, such as SBS Dealers, to execute informed trades with

less price impact. The overall effects of these final rules on price discovery and informational efficiency in security-based swap markets are, therefore, difficult to assess.

The final suitability and special entity rules would require SBS Dealers to evaluate the suitability of trades for non-dealer counterparties and special entities when making recommendations to such counterparties, unless the SBS Dealer can rely on the institutional suitability alternative to fulfill its customer-specific suitability obligations. SBS Dealers may have superior information about security-based swaps, but may face an informational asymmetry when analyzing the hedging needs, risk tolerance and horizons of their counterparties. This requirement may preclude SBS Dealers from recommending some security-based swaps that may be truly suitable for a given counterparty, while recommending other security-based swaps that may be less suitable. The presence and magnitude of this economic effect depends on the tradeoff between the severity of information asymmetry concerning the nature of the swap and asymmetry concerning the counterparty, and potential losses and risks of investing in unsuitable security-based swaps relative to foregone profits from not investing in suitable security-based swaps.

Suitability requirements and resulting costs could further increase the costs to SBS Dealers of recommending security-based swaps to non-dealer counterparties, particularly counterparties with which the SBS Dealer has had no prior transactions, and counterparties that do not meet institutional suitability requirements. We also recognize that these rules may limit the ability of SBS Dealers to recommend some security-based swaps to certain counterparties, which may decrease the potential range of counterparties and products that some SBS Dealers may intermediate. If these effects result in SBS Dealers refraining from advising or transacting with some counterparties, and these

counterparties are otherwise unable to receive advice or enter into 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, adverse effects on market participation and liquidity may follow. However, as we noted previously, market data available to us 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 customer-specific suitability obligations by, among other things, making the determination that a counterparty's agent is capable of independently evaluating investment risk, as well as the exception of anonymous SEF executed security-based swaps, we do not believe that market access is likely to be restricted.

The final pay to play rules may reduce pay to play practices among SBS Dealers. To the extent that political contributions may currently be influencing counterparty and security-based swap selection, these rules may mitigate these influences and enhance allocative efficiency of municipal entities and facilitate greater quality-based competition of SBS Dealers. However, if some SBS Dealers become subject to a two-year time out due to inadvertent violations of the de minimis thresholds by themselves or their covered associates, and are unable to secure exemptive relief, fewer SBS Dealers may be able to transact with municipal entities in security-based swaps, which may increase the pricing power and decrease quality of execution of swaps offered to municipal entities by the remaining SBS Dealers. We note that SBS Dealers will have to keep updated records of

political contributions of their covered associates, ensure their accuracy, promptly discover triggering contributions and seek their return. The costs of implementing such policies and procedures related to political contributions of covered associates will be greater for larger SBS Dealers with multiple layers of supervision and a higher number of covered associates with shorter tenures. While other business conduct rules tend to impose fixed burdens, which represent a higher fraction of net income for smaller SBS Dealers, this particular requirement may be significantly more costly for larger SBS Dealers.

Further, under these final rules, representatives of special entities transacting with SBS Entities are likely to be employees or independent representatives subject to Commission, CFTC or SRO pay to play rules. To the extent that some special entity representatives currently intermediating transactions with SBS Entities are not registered investment advisers, municipal advisors, other fiduciaries or employees, they may be unable to represent special entities in security-based swap transactions with SBS Entities unless they register as such. This may decrease competition among qualified investment representatives of special entities, or incentivize unregistered representatives to register, for instance, as investment advisers with the Commission or as municipal advisors with the MSRB.

The direct and indirect costs of compliance with these final business conduct rules may be recovered by SBS Entities in the form of higher transaction costs or more adverse non-price terms of security-based swaps offered to counterparties. To the extent that these costs cannot be recovered, incentives for some entities to operate as registered U.S.

SBS Entities may be reduced,[1765] which may adversely affect competition in security-based swap markets. In addition, some counterparties may lose access to the market for OTC swaps. However, we note that, as discussed above, anonymous SEF transactions are exempt from some of the substantive requirements of these final rules, which may allow such counterparties to retain access to security-based swaps. Further, to the extent that these rules impose costs and restrictions on non-SEF trades that are not born by SBS Entities related to SEF trades, the volume of transactions executed on SEFs may increase. We recognize that, as a result, these final rules may increase the programmatic costs and benefits of pending SEF and clearing rules, with their follow on effects on efficiency, competition and capital formation, which will be evaluated in pending SEF and clearing rules. We recognize similarities between CFTC external business conduct standards for Swap Entities, FINRA rules for broker dealers and the rules being adopted. Due to extensive cross-market participation, many of the entities expected to register as SBS Entities will have already registered with the CFTC as Swap Entities or with the Commission as broker dealers, yet others may already be subject to similar MSRB rules. To the extent that these final rules involve initial compliance costs, dually registered SBS entities may experience significantly lower initial compliance costs. At the same time, new entrants and SBS Entities that are not dually registered may face higher costs. Competitive effects of these final business conduct rules primarily stem from differences in burdens incurred by dual registrants on the one hand, and non-dually registered SBS Entities and new entrants on the other.

[1765] See U.S. Activity Adopting Release, 81 FR at 8629.

In addition to the competitive effects of compliance burdens above, the cross-border approach adopted in these final rules may impact competition between U.S. and non-U.S. SBS Entities and their U.S. and non-U.S. personnel. A substituted compliance regime for business conduct requirements and their application to non-U.S. persons' dealing transactions that are arranged, negotiated, or executed using personnel located in the United States may mitigate competitive frictions between U.S. and non-U.S. SBS Dealers that transact with foreign counterparties, and may promote market efficiency. The final cross-border approach to business conduct requirements will result in a uniform application of these requirements to U.S. and non-U.S. SBS Dealers and their agents. If only U.S. SBS Dealers and their agents were subject to disclosure, suitability and other requirements in these final rules when transacting with foreign counterparties, the costs of such disclosures would primarily be incurred by U.S. SBS Dealers, their agents, and their counterparties. In contrast, non-U.S. SBS Dealers and their agents, including personnel located in the United States, would potentially have a competitive advantage over U.S. SBS Dealers in serving non-U.S. person counterparties using personnel located in a U.S. branch or office, were their activities not subject to the same requirements.[1766] Therefore, the cross-border application of these final business conduct rules may enhance competition among these SBS Dealers.

Access to SEC-regulated security-based swap markets increases hedging opportunities for financial market intermediaries; such hedging opportunities reduce risks and allow intermediaries to facilitate a greater volume of financing activities, including

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[1766] See, e.g., Arnoud W.A. Boot, Silva Dezelan, and Todd T. Milbourn, "Regulatory Distortions in a Competitive Financial Services Industry," Journal of Financial Services Research, Vol. 17, No. 1 (2000).

issuance of equity and debt securities, and therefore contribute to capital formation. As we have stated in other releases,[1767] this may be particularly true in underlying securities markets, where potential pricing and liquidity effects in security-based swap markets may feedback and impact the market for reference entity securities. Security-based swap markets may enable better risk mitigation by investors in underlying reference securities, such as CDS hedging of the credit risk of corporate bond investments. The possible contraction in security-based swap market participation by SBS Entities due to costs of compliance with these final rules may adversely impact underlying reference security markets, including pricing and liquidity in corporate bond and equity markets. This may have a negative effect on the ability of firms to raise debt and equity capital to finance real investment. However, the spillover from potential deterioration in security-based swap markets into underlying reference security markets may also be positive. Sophisticated institutional investors transact across CDS and bond markets to trade on information pertaining to the credit risk of underlying reference debt. A potential negative shock to security-based swap market liquidity and dealing by SBS Entities with non-SBS Entity counterparties as a result of required compliance with these final rules may, in fact, drive sophisticated institutions to search for liquidity pools and lower price impact of informed trades to reference security markets. If institutions begin to trade more actively in underlying reference security markets, such as corporate bond markets as a result, there may be positive effects on liquidity and informational efficiency of

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[1767] See Registration Adopting Release, 80 FR 49008, supra note 989.

corporate bond and equity markets.[1768] This may enable firms to raise more debt and equity at potentially lower costs to finance real investment.

VII. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act ("RFA")[1769] requires Federal agencies, in promulgating rules, to consider the impact of those rules on small entities. The Commission certified in the Proposing Release, pursuant to Section 605(b) of the RFA,[1770] that proposed Rules 15Fh-1 through 15Fh-6 and Rule 15Fk-1 would not, if adopted, have a significant economic impact on a substantial number of "small entities."[1771] The Commission received no comments on this certification.

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;[1772] 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)

1768 See Section VI.B.5.

1769 5 U.S.C. 601 *et seq.*

1770 5 U.S.C. 605(b).

1771 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 *Statement of Management on Internal Control*, Exchange Act Release No. 18451 (Jan. 28, 1982), 47 FR 5215 (Feb. 4, 1982).

1772 See 17 CFR 240.0-10(a).

under the Exchange Act,[1773] 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.[1774] 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. Under the standards adopted by the Small Business Administration, small entities in the finance and insurance industry include the following: (i) for entities in credit intermediation and related activities,[1775] entities with $550 million or less in assets or, (ii) for non-depository credit intermediation and certain other activities,[1776] $38.5 million or less in annual receipts; (iii) for entities in financial investments and related activities,[1777]

1773 See 17 CFR 240.17a-5(d).

1774 See 17 CFR 240.0-10(c).

1775 Including commercial banks, savings institutions, credit unions, firms involved in other depository credit intermediation, credit card issuing, sales financing, consumer lending, real estate credit, and international trade financing. 13 CFR 121.201 at Subsector 522.

1776 Including firms involved in secondary market financing, all other non-depository credit intermediation, mortgage and nonmortgage loan brokers, financial transactions processing, reserve, and clearing house activities, and other activities related to credit intermediation. 13 CFR 121.201 at Subsector 522.

1777 Including firms involved in investment banking and securities dealing, securities brokerage, commodity contracts dealing, commodity contracts brokerage, securities and commodity exchanges, miscellaneous intermediation, portfolio management, providing investment advice, trust, fiduciary and custody activities, and miscellaneous financial investment activities. 13 CFR 121.201 at Subsector 523.

entities with $38.5 million or less in annual receipts; (iv) for insurance carriers and entities in related activities,[1778] entities with $38.5 million or less in annual receipts, or 1,500 employees for direct property and casualty insurance carriers; and (v) for funds, trusts, and other financial vehicles,[1779] entities with $32.5 million or less in annual receipts.[1780]

With respect to SBS Entities, based on feedback from market participants and our information about the security-based swap markets, the Commission continues to believe that (1) the types of entities that would engage in more than a de minimis amount of dealing activity involving security-based swaps—which generally would be large financial institutions—would not be "small entities" for purposes of the RFA; and (2) the types of entities that may have security-based swap positions above the level required to be "major security-based swap participants" would not be "small entities" for purposes of the RFA.[1781]

1778 Including direct life insurance carriers, direct health and medical insurance carriers, direct property and casualty insurance carriers, direct title insurance carriers, other direct insurance (except life, health and medical) carriers, reinsurance carriers, insurance agencies and brokerages, claims adjusting, third party administration of insurance and pension funds, and all other insurance related activities. 13 CFR 121.201 at Subsector 524.

1779 Including pension funds, health and welfare funds, other insurance funds, open-end investment funds, trusts, estates, and agency accounts, real estate investment trusts and other financial vehicles. 13 CFR 121.201 at Subsector 525.

1780 See 13 CFR 121.201.

1781 See Recordkeeping Release, 79 FR 25194, 25296-97 & n.1441, supra note 242; 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. 66868 (Apr. 27, 2012), 77 FR 30596, 30743 (May 23, 2012) (joint Commission / CFTC final rules); Registration Adopting Release, 80 FR 48964, 49012-49013, supra note 989.

For the foregoing reasons, the Commission certifies that the SBS Entity registration rules and forms, as adopted would not have a significant economic impact on a substantial number of small entities for purposes of the RFA.

Statutory Basis and Text of Final Rules

Pursuant to the Exchange Act and, particularly, Sections 2, 3(b), 3C, 9, 10, 11A, 15, 15F, 17(a) and (b), 23(a) and 30(c) thereof (15 U.S.C. 78b, 78c(b), 78i(i), 78i(j), 78j, 78k-1, 78o, 78o-10, 78q(a) and (b), 78w(a) and 78dd(c)), the Commission is adopting Rule 3a71-6, Rules 15Fh-1 through 15Fh-6, and Rule 15Fk-1, and is amending Rules 3a67-10 and 3a71-3, to address the business conduct obligations of security-based swap dealers and major security-based swap participants, including the cross-border application of those obligations and the availability of substituted compliance in connection with those obligations.

List of Subjects in 17 CFR Part 240

Brokers, Reporting and recordkeeping requirements, Securities.

Text of the Final Rules

For the reasons set forth in the preamble, the Securities and Exchange Commission is amending 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 continues to read, and sectional authorities for sections 240.3a71-6, 240.15Fh-1 through 240.15Fh-6, and 240.15Fk-1 are added in numerical order to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78c-3, 78c-5, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78n-1, 78o, 78o-4, 78o-10, 78p, 78q, 78q-1, 78s, 78u-5, 78w, 78x, 78dd, 78ll, 78mm, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7201 et seq., and 8302; 7 U.S.C. 2(c)(2)(E); 12 U.S.C. 5221(e)(3); 18 U.S.C. 1350; and Pub. L. 111-203, 939A, 124 Stat. 1376, (2010), unless otherwise noted.

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Section 240.3a67-10, 240.3a71-3, 240.3a71-4, 240.3a71-5, and 240.3a71-6 are also issued under Pub. L. 111-203, secs. 712, 761(b), 124 Stat. 1754 (2010), and 15 U.S.C. 78dd(c).

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Sections 240.15Fh-1 through 240.15Fh-6 and 240.15Fk-1 are also issued under sec. 943, Pub. L. No. 111-203, 124 Stat. 1376.

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2. § 240.3a67-10 is amended by:

a. Adding paragraphs (a)(5) and (6); and

b. Adding paragraph (d).

The additions read as follows:

§ 240.3a67-10 Foreign major security-based swap participants.

(a) * * *

(5) U.S. major security-based swap participant means a major security-based swap participant, as defined in section 3(a)(67) of the Act (15 U.S.C. 78c(a)(67)), and the rules and regulations thereunder, that is a U.S. person.

(6) Foreign major security-based swap participant means a major security-based swap participant, as defined in section 3(a)(67) of the Act (15 U.S.C. 78c(a)(67)), and the rules and regulations thereunder, that is not a U.S. person.

* * * * *

(d) Application of customer protection requirements. (1) A registered foreign major security-based swap participant shall not be subject to the requirements relating to business conduct standards described in section 15F(h) of the Act (15 U.S.C. 78o–10(h)), and the rules and regulations thereunder, other than rules and regulations prescribed by the Commission pursuant to section 15F(h)(1)(B) of the Act (15 U.S.C. 78o–10(h)(1)(B)), with respect to a security-based swap transaction with a counterparty that is not a U.S. person or with a counterparty that is a U.S. person in a transaction conducted through a foreign branch of the U.S. person.

(2) A registered U.S. major security-based swap participant shall not be subject to the requirements relating to business conduct standards described in section 15F(h) of the Act (15 U.S.C. 78o–10(h)), and the rules and regulations thereunder, other than rules and regulations prescribed by the Commission pursuant to section 15F(h)(1)(B) of the Act (15 U.S.C. 78o– 10(h)(1)(B)), with respect to a security-based swap transaction that constitutes a transaction conducted through a foreign branch of the registered U.S. major security-based swap participant with a non-U.S. person or with a U.S.-person counterparty that constitutes a transaction conducted through a foreign branch of that U.S.-person counterparty.

3. § 240.3a71-3 is amended by:

a. Adding paragraphs (a)(6) through (9); and

b. Adding paragraph (c).

The additions read as follows:

§ 240.3a71-3 Cross-border security-based swap dealing activity.

(a) * * *

(6) U.S. security-based swap dealer means a security-based swap dealer, as defined in section 3(a)(71) of the Act (15 U.S.C. 78c(a)(71)), and the rules and regulations thereunder, that is a U.S. person.

(7) Foreign security-based swap dealer means a security-based swap dealer, as defined in section 3(a)(71) of the Act (15 U.S.C. 78c(a)(71)), and the rules and regulations thereunder, that is not a U.S. person.

(8) U.S. business means:

(i) With respect to a foreign security-based swap dealer:

(A) Any security-based swap transaction entered into, or offered to be entered into, by or on behalf of such foreign security-based swap dealer, with a U.S. person (other than a transaction conducted through a foreign branch of that person); or

(B) Any security-based swap transaction arranged, negotiated, or executed by personnel of the foreign security-based swap dealer located in a U.S. branch or office, or by personnel of an agent of the foreign security-based swap dealer located in a U.S. branch or office; and

(ii) With respect to a U.S. security-based swap dealer, any transaction entered into or offered to be entered into by or on behalf of such U.S. security-based swap dealer, other than a transaction conducted through a foreign branch with a non-U.S. person or with a U.S.-person counterparty that constitutes a transaction conducted through a foreign branch of the counterparty.

(9) Foreign business means security-based swap transactions entered into, or offered to be entered into, by or on behalf of a security-based swap dealer, other than the U.S. business of such person.

* * * * *

(c) Application of customer protection requirements. A registered security-based swap dealer, with respect to its foreign business, shall not be subject to the requirements relating to business conduct standards described in section 15F(h) of the Act (15 U.S.C. 78o-10(h)), and the rules and regulations thereunder, other than the rules and regulations prescribed by the Commission pursuant to section 15F(h)(1)(B) of the Act (15 U.S.C. 78o-10(h)(1)(B)).

4. Add § 240.3a71-6 to read as follows:

§ 240.3a71–6 Substituted compliance for security-based swap dealers and major security-based swap participants.

(a) Determinations—(1) In general. Subject to paragraph (a)(2) of this section, the Commission may, conditionally or unconditionally, by order, make a determination with respect to a foreign financial regulatory system that compliance with specified requirements under such foreign financial regulatory system by a registered security-based swap dealer and/or by a registered major security-based swap participant (each a "security-based swap entity"), or class thereof, may satisfy the corresponding requirements identified in paragraph (d) of this section that would otherwise apply to such security-based swap entity (or class thereof).

(2) Standard. The Commission shall not make a substituted compliance determination under paragraph (a)(1) of this section unless the Commission:

(i) Determines that the requirements of such foreign financial regulatory system applicable to such security-based swap entity (or class thereof) or to the activities of such security-based swap entity (or class thereof) are comparable to otherwise applicable requirements, after taking into account such factors as the Commission determines are appropriate, such as the scope and objectives of the relevant foreign regulatory requirements (taking into account the applicable criteria set forth in paragraph (d) of this section), as well as the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by a foreign financial regulatory authority or authorities in such system to support its oversight of such security-based swap entity (or class thereof) or of the activities of such security-based swap entity (or class thereof); and

(ii) Has entered into a supervisory and enforcement memorandum of understanding and/or other arrangement with the relevant foreign financial regulatory authority or authorities under such foreign financial regulatory system addressing supervisory and enforcement cooperation and other matters arising under the substituted compliance determination.

(3) Withdrawal or modification. The Commission may, on its own initiative, by order, modify or withdraw a substituted compliance determination under paragraph (a)(1) of this section, after appropriate notice and opportunity for comment.

(b) Reliance by security-based swap entities. A registered security-based swap entity may satisfy the requirements described in paragraph (d) of this section by complying with corresponding law, rules and regulations under a foreign financial regulatory system, provided:

(1) The Commission has made a substituted compliance determination pursuant to paragraph (a)(1) of this section regarding such foreign financial regulatory system providing that compliance with specified requirements under such foreign financial regulatory system by such registered security-based swap entity (or class thereof) may satisfy the corresponding requirements described in paragraph (d) of this section; and

(2) Such registered security-based swap entity satisfies any conditions set forth in a substituted compliance determination made by the Commission pursuant to paragraph (a)(1) of this section.

(c) Requests for determinations. (1) A party or group of parties that potentially would comply with specified requirements pursuant to paragraph (a)(1), or any foreign financial regulatory authority or authorities supervising such a party or its security-based swap activities, may file an application, pursuant to the procedures set forth in § 240.0–13, requesting that the Commission make a substituted compliance determination pursuant to paragraph (a)(1) of this section, with respect to one or more requirements described in paragraph (d) of this section.

(2) Such a party or group of parties may make a request under paragraph (c)(1) of this section only if:

(i) Each such party, or the party's activities, is directly supervised by the foreign financial regulatory authority or authorities with respect to the foreign regulatory requirements relating to the applicable requirements described in paragraph (d) of this section; and

(ii) Each such party provides the certification and opinion of counsel as described in § 240.15Fb2-4(c), as if the party were subject to that requirement at the time of the request.

(3) Such foreign financial authority or authorities may make a request under paragraph (c)(1) of this section only if each such authority provides adequate assurances that no law or policy of any relevant foreign jurisdiction would impede the ability of any entity that is directly supervised by the foreign financial regulatory authority and that may register with the Commission as a security-based swap dealer or major security-based swap participant to provide prompt access to the Commission to such entity's books and records or to submit to onsite inspection or examination by the Commission.

(d) Eligible requirements. The Commission may make a substituted compliance determination under paragraph (a)(1) of this section to permit security-based swap entities that are not U.S. persons (as defined in § 240.3a71-3(a)(4)), but not security-based swap entities that are U.S. persons, to satisfy the following requirements by complying with comparable foreign requirements:

(1) Business conduct and supervision. The business conduct and supervision requirements of sections 15F(h) and (j) of the Act (15 U.S.C. 78o-10(h) and (j)) and §§ 240.15Fh-3 through 15Fh-6, other than the antifraud provisions of section 15F(h)(4)(A) of the Act and § 240.15Fh-4(a), and other than the provisions of sections 15F(j)(3) and 15F(j)(4)(B) of the Act; provided, however, that prior to making such a substituted compliance determination the Commission intends to consider whether the information that is required to be provided to counterparties pursuant to the requirements of the foreign financial regulatory system, the counterparty protections under the requirements

of the foreign financial regulatory system, the mandates for supervisory systems under the requirements of the foreign financial regulatory system, and the duties imposed by the foreign financial regulatory system, are comparable to those associated with the applicable provisions arising under the Act and its rules and regulations.

(2) Chief compliance officer. The chief compliance officer requirements of section 15F(k) of the Act (15 U.S.C. 78o-10(k)) and § 240.15Fk-1; provided, however, that prior to making such a substituted compliance determination the Commission intends to consider whether the requirements of the foreign financial regulatory system regarding chief compliance officer obligations are comparable to those required pursuant to the applicable provisions arising under the Act and its rules and regulations.

5. Add §§240.15Fh-1 through 240.15Fh-6, and §240.15Fk-1 to read as follows:

§240.15Fh-1 Scope and reliance on representations.

(a) 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. Sections 240.15Fh-3(a) through 240.15Fh-3(f), 240.15Fh-4(b) and 240.15Fh-5 are not applicable to security-based swaps that security-based swap dealers or major security-based swap participants enter into with their majority-owned affiliates. For these purposes the counterparties to a security-based swap are majority-owned affiliates if

one counterparty directly or indirectly owns a majority interest in the other, or if a third party directly or indirectly owns a majority interest in both counterparties to the security-based swap, where ‘‘majority interest’’ is the right to vote or direct the vote of a majority of a class of voting securities of an entity, the power to sell or direct the sale of a majority of a class of voting securities of an entity, or the right to receive upon dissolution or the contribution of a majority of the capital of a partnership.

(b) Reliance on representations. A security-based swap dealer or major security-based swap participant may rely on written representations from the counterparty or its representative to satisfy its due diligence requirements under §240.15Fh, unless it has information that would cause a reasonable person to question the accuracy of the representation.

§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) With respect to a special entity as defined in §240.15Fh-2(d)(3):

(i) The special entity represents in writing that it has a fiduciary as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) that is responsible for representing the special entity in connection with the security-based swap;

(ii) The fiduciary represents in writing that it acknowledges that the security-based swap dealer is not acting as an advisor; and

(iii) The special entity represents in writing:

(A) That it will comply in good faith with written policies and procedures reasonably designed to ensure that any recommendation the special entity receives from the security-based swap dealer involving a security-based swap transaction is evaluated by a fiduciary before the transaction is entered into; or

(B) That any recommendation the special entity receives from the security-based swap dealer involving a security-based swap transaction will be evaluated by a fiduciary before the transaction is entered into.

(2) With respect to any special entity:

(i) The special entity represents in writing that:

(A) It acknowledges that the security-based swap dealer is not acting as an advisor; and

(B) The special entity will rely on advice from a qualified independent representative as defined in §240.15Fh-5(a); and

(ii) 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)(65) of the Act and the rules and regulations thereunder and in section 1a of the Commodity Exchange Act (7 U.S.C. 1a) and the rules and regulations thereunder.

(c) 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.

(d) Special entity means:

(1) A Federal agency;

(2) A State, State agency, city, county, municipality, other political subdivision of a State, or any instrumentality, department, or a corporation of or established by a State or political subdivision of a State;

(3) Any employee benefit plan, subject to Title I of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002);

(4) Any employee benefit plan defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) and not otherwise defined as a special entity, unless such employee benefit plan elects not to be a special entity by notifying a security-based swap dealer or major security-based swap participant of its election prior to entering into a security-based swap with the particular security-based swap dealer or major security-based swap participant;

(5) 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

(6) Any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986.

(e) A person is subject to a statutory disqualification for purposes of §240.15Fh-5 if that person would be subject to a statutory disqualification, as described in section 3(a)(39)(A)-(F) 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 meets the

eligibility standards for an eligible contract participant before entering into a security-based swap with that counterparty, provided that the requirements of this paragraph (a)(1) shall not apply to a transaction executed on a registered national securities exchange.

(2) Special entity. A security-based swap dealer or a major security-based swap participant shall verify whether a counterparty is a special entity before entering into a security-based swap with that counterparty, unless the transaction is executed on a registered or exempt security-based swap execution facility or registered national securities exchange, and the security-based swap dealer or major security-based swap participant does not know the identity of the counterparty at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer or major security-based swap participant to comply with the obligations of paragraph (a) of this section.

(3) Special entity election. In verifying the special entity status of a counterparty pursuant to §240.15Fh-3(a)(2), a security-based swap dealer or major security-based swap participant shall verify whether a counterparty is eligible to elect not to be a special entity under §240.15Fh-2(d)(4) and, if so, notify such counterparty of its right to make such an election.

(b) Disclosure. At a reasonably sufficient time prior to entering into a security-based swap, a security-based swap dealer or major security-based swap participant shall disclose to a counterparty, other than a security-based swap dealer, major security-based swap participant, swap dealer or major swap participant, material information concerning the security-based swap in a manner reasonably designed to allow the

counterparty to assess the material risks and characteristics and material incentives or conflicts of interest, as described below, so long as the identity of the counterparty is known to the security-based swap dealer or major security-based swap participant at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer or major security-based swap participant to comply with the obligations of paragraph (b) of this section.

(1) Material risks and characteristics means the material risks and characteristics of the particular security-based swap, which may include:

(i) Market, credit, liquidity, foreign currency, legal, operational, and any other applicable risks; and

(ii) The material economic terms of the security-based swap, the terms relating to the operation of the security-based swap, and the rights and obligations of the parties during the term of the security-based swap.

(2) Material incentives or conflicts of interest means 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 this paragraph (b), 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 request of the counterparty, the daily mark that the security-based swap dealer or major security-based swap participant receives from the appropriate clearing agency;

(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; and

(3) The security-based swap dealer or major security-based swap participant shall provide the daily mark without charge to the counterparty and without restrictions on the internal use of the daily mark by the counterparty.

(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, so long as the identity of the counterparty is known to the security-based swap dealer or major security-based swap participant at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer or major security-based swap participant to comply with the obligations of paragraph (d) of this section:

(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) of this section shall be used to clear the security-based swap subject to section 3C(g)(5) of the Act.

(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 this paragraph (d), 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 written 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 paragraph (e) 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; and

(3) Information regarding the authority of any person acting for such counterparty.

(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:

(i) Undertake reasonable diligence to understand the potential risks and rewards associated with the recommended security-based swap or trading strategy involving a security-based swap; and

(ii) Have a reasonable basis to believe 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 involving a security-based swap.

(2) A security-based swap dealer may also fulfill its obligations under paragraph (f)(1)(ii) of this section with respect to an institutional 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 with regard to the relevant security-based swap or trading strategy involving a security-based swap; 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)(2)(i) of this section if it receives written representations, as provided in §240.15Fh-1(b), that:

(i) In the case of a counterparty that is not a special entity, the counterparty has complied in good faith with written policies and procedures that are reasonably designed to ensure that the persons responsible for evaluating the recommendation and making trading decisions on behalf of the counterparty are capable of doing so; or

(ii) In the case of a counterparty that is a special entity, satisfy the terms of the safe harbor in §240.15Fh-5(b).

(4) For purposes of paragraph (f)(2) of this section, an institutional counterparty is a counterparty that is an eligible contract participant as defined in clauses (A)(i), (ii), (iii), (iv), (viii), (ix) or (x), or clause (B)(ii) (other than a person described in clause (A)(v)) of section 1a(18) of the Commodity Exchange Act (7 U.S.C. 1(a)(18)) and the rules and regulations thereunder, or any person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.

(g) 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.

(h) Supervision—(1) In general. A security-based swap dealer or major security-based swap participant shall establish and maintain a system to supervise, and shall diligently supervise, its business and the activities of its associated persons. Such a

system shall be reasonably designed to prevent 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 (h)(1) of this section shall, at a minimum, 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, either by virtue of experience or training, to carry out their assigned responsibilities; and

(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 and the activities of its associated persons that are reasonably designed to prevent violations of applicable federal 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 applicable federal securities laws and the rules and regulations thereunder;

(D) Procedures to conduct a reasonable investigation regarding the good 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 or a trading relationship 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;

(F) A description of the supervisory system, including the titles, qualifications and locations of supervisory persons and the responsibilities of each

supervisory 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; provided, however, that if the security-based swap dealer or major security-based swap participant determines, with respect to any of its supervisory personnel, that compliance with this requirement is not possible because of the firm's size or a supervisory person's position within the firm, the security-based swap dealer or major security-based swap participant must document the factors used to reach such determination and how the supervisory arrangement with respect to such supervisory personnel otherwise complies with paragraph (h)(1) of this section, and include a summary of such determination in the annual compliance report prepared by the security-based swap dealer's or major security-based swap participant's chief compliance officer pursuant to §240.15Fk-1(c);

(H) Procedures reasonably designed to prevent the supervisory system required by paragraph (h)(1) of this section from being compromised due to the conflicts of interest that may be present with respect to the associated person being supervised, including the position of such person,

the revenue such person generates for the security-based swap dealer or major security-based swap participant, or any compensation that the associated person conducting the supervision may derive from the associated person being supervised; and

(I) 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 as required in §240.15Fh-3(h)(2)(iii), 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 such written policies and procedures and documented system and

did not have a reasonable basis to believe that such 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 to all associated persons to whom such amendments are relevant based on their activities and responsibilities.

§240.15Fh-4 Antifraud provisions for security-based swap dealers and major security-based swap participants; special requirements for security-based swap dealers acting as advisors to special entities.

(a) Antifraud provisions. 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) Special requirements for security-based swap dealers acting as advisors to special entities. 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 make a reasonable determination that any security-based swap or trading strategy involving a security-based swap recommended by the security-based swap dealer is 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 hedging, investment, financing or other 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) Exception. The requirements of this paragraph (b) shall not apply with respect to a security-based swap if:

(i) The transaction is executed on a registered or exempt 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 a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer to comply with the obligations of paragraph (b) of this section.

§240.15Fh-5 Special requirements for security-based swap dealers and major security-based swap participants acting as counterparties to special entities.

(a)(1) 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, other than a special entity defined in §240.15Fh-2(d)(3), must have a reasonable basis to believe that the special entity has a qualified independent representative. For these purposes, a qualified independent representative is a representative that:

(i) Has sufficient knowledge to evaluate the transaction and risks;

(ii) Is not subject to a statutory disqualification;

(iii) Undertakes a duty to act in the best interests of the special entity;

(iv) Makes appropriate and timely disclosures to the special entity of material information concerning the security-based swap;

(v) Evaluates, consistent with any guidelines provided by the special entity, the fair pricing and the appropriateness of the security-based swap;

(vi) In the case of a special entity defined in §§240.15Fh-2(d)(2) or (5), 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)(1)(vi) shall not apply if the independent representative is an employee of the special entity; and

(vii) Is independent of the security-based swap dealer or major security-based swap participant.

(A) 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.

(B) 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:

(1) The representative is not and, within one year of representing the special entity in connection with the security-based swap, was not an associated person of the security-based swap dealer or major security-based swap participant;

(2) The representative provides timely disclosures to the special entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the special entity and complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest; and

(3) The security-based swap dealer or major security-based swap participant did not refer, recommend, or introduce the representative to the special entity within one year of the representative's representation of the special entity in connection with the security-based swap.

(2) 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 as defined in §240.15Fh-2(d)(3) must have a reasonable basis to believe that the special entity has a representative that is a fiduciary as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).

(b) Safe harbor. (1) A security-based swap dealer or major security-based swap participant shall be deemed to have a reasonable basis to believe that the special entity, other than a special entity defined in §240.15Fh-2(d)(3), has a representative that satisfies the applicable requirements of paragraph (a)(1) of this section, provided that:

(i) The special entity represents in writing to the security-based swap dealer or major security-based swap participant that it has complied in good faith with written policies and procedures reasonably designed to ensure that it has selected a representative that satisfies the applicable requirements of

paragraph (a)(1) of this section, and that such policies and procedures provide for ongoing monitoring of the performance of such representative consistent with the requirements of paragraph (a)(1) of this section; and

(ii) The representative represents in writing to the special entity and security-based swap dealer or major security-based swap participant that the representative:

(A) Has policies and procedures reasonably designed to ensure that it satisfies the applicable requirements of paragraph (a)(1) of this section;

(B) Meets the independence test in paragraph (a)(1)(vii) of this section; has the knowledge required under paragraph (a)(1)(i) of this section; is not subject to a statutory disqualification under paragraph (a)(1)(ii) of this section; undertakes a duty to act in the best interests of the special entity as required under paragraph (a)(1)(iii) of this section; and is subject to the requirements regarding political contributions, as applicable, under paragraph (a)(1)(vi) of this section; and

(C) Is legally obligated to comply with the applicable requirements of paragraph (a)(1) of this section by agreement, condition of employment, law, rule, regulation, or other enforceable duty.

(2) A security-based swap dealer or major security-based swap participant shall be deemed to have a reasonable basis to believe that a special entity defined in §240.15Fh-2(d)(3) of this section has a representative that satisfies the applicable requirements in paragraph (a)(2) of this section, provided that the special entity provides in writing to the security-based swap dealer or major security-based

swap participant the representative's name and contact information, and represents in writing that the representative is a fiduciary as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002).

(c) 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 in connection with the security-based swap and, if the security-based swap dealer engages in business with the counterparty in more than one capacity, the security-based swap dealer shall disclose the material differences between such capacities and any other financial transaction or service involving the counterparty.

(d) The requirements of this section shall not apply with respect to a security-based swap if:

(1) The transaction is executed on a registered or exempt 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 a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer or major security-based swap participant to comply with the obligations of paragraphs (a) through (c) of this section.

§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 federal, 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 (a)(2)(i) and (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) of this section 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, if a natural person:

(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 executed on a registered national securities exchange or registered or exempt security-based swap execution facility where the security-based swap dealer does not know the identity of the counterparty to the transaction at a reasonably sufficient time prior to execution of the transaction to permit the security-based swap dealer to comply with the obligations of paragraph (b)(1) of this section.

(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 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 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 (b)(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., federal, 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 that has more than 50 covered associates may not rely on paragraph (e)(1) of this section more than three times in any 12-month period, while a security-based swap dealer that has 50 or fewer covered associates may not rely on paragraph (e)(1) of this section more than twice in any 12-month period.

(3) A security-based swap dealer may not rely on paragraph (e)(1) of this section more than once for any covered associate, regardless of the time between contributions.

§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; and

(2) Take reasonable steps to ensure that the registrant establishes, maintains and reviews written policies and procedures reasonably designed to achieve 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 by:

(i) Reviewing 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 involve preparing the registrant's annual assessment of its 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;

(ii) Taking reasonable steps to ensure that the registrant establishes, maintains and reviews policies and procedures reasonably designed to remediate

non-compliance issues identified by the chief compliance officer through any means, including any:

(A) Compliance office review;

(B) Look-back;

(C) Internal or external audit finding;

(D) Self-reporting to the Commission and other appropriate authorities; or

(E) Complaint that can be validated; and

(iii) Taking reasonable steps to ensure that the registrant establishes and follows procedures reasonably designed for the handling, management response, remediation, retesting, and resolution of non-compliance issues;

(3) In consultation with the board of directors or the senior officer of the security-based swap dealer or major security-based swap participant, take reasonable steps to resolve any material conflicts of interest that may arise; and

(4) Administer each policy and procedure that is required to be established pursuant to section 15F of the Act and the rules and regulations thereunder.

(c) Annual reports—(1) In general. The chief compliance officer shall annually prepare and sign a compliance report that contains a description of the written policies and procedures 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 assessment of the effectiveness 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 registrant's policies and procedures since the date of the preceding compliance report;

(C) Any areas for improvement, and recommended potential or prospective changes or improvements to its compliance program and resources devoted to compliance;

(D) Any material non-compliance matters identified; and

(E) The financial, managerial, operational, and staffing resources set aside for 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, including any material deficiencies in such resources.

(ii) A compliance report under paragraph (c)(1) of this section also shall:

(A) Be submitted to the Commission within 30 days following the deadline for filing the security-based swap dealer's or major security-based swap participant's annual financial report 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 prior to submission to the Commission;

(C) Be discussed in one or more meetings conducted by the senior officer with the chief compliance officer(s) in the preceding 12 months, the subject of which addresses the obligations in this section; and

(D) Include a certification by the chief compliance officer or senior officer that, to the best of his or her knowledge and reasonable belief and under penalty of law, the information contained in the compliance report is accurate and complete in all material respects.

(iii) Extensions of time. A security-based swap dealer or major security-based swap participant may request from the Commission an extension of time to submit its compliance report, provided the registrant's failure to timely submit the report could not be eliminated by the registrant without unreasonable effort or expense. Extensions of the deadline will be granted at the discretion of the Commission.

(iv) Incorporation by reference. A security-based swap dealer or major security-based swap participant may incorporate by reference sections of a compliance report that have been submitted within the current or immediately preceding reporting period to the Commission.

(v) Amendments. A security-based swap dealer or major security-based swap participant shall promptly submit an amended compliance report if material errors or omissions in the report are identified. An amendment must contain the certification required under paragraph (c)(2)(ii)(D) of this section.

(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 section, 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 associated person of a security-based swap dealer or major security-based swap participant that can be supported upon reasonable investigation.

(4) A material non-compliance matter means any non-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.

Brent J. Fields
Secretary

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