

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

June 30, 2011

Yesterday the Securities and Exchange Commission (SEC) proposed rules to establish business conduct standards for security-based swap dealers and major security-based swap participants (Proposed Rules), as mandated by Section 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). SEC Chairman Mary Schapiro stated that the Proposed Rules “are intended to establish a framework that protects investors and also promotes efficiency, competition, and capital formation.” According to Chairman Schapiro, the Proposed Rules would level the playing field in the security-based swaps market by requiring transparency and ensuring that security-based swap customers are treated fairly.

In developing the Proposed Rules, the SEC consulted with the Commodity Futures Trading Commission (CFTC), other federal regulators and market participants. The SEC also reviewed public comments submitted in response to the CFTC’s proposed business conduct standards, which were the subject of several separate proposed rulemakings issued last year.¹ The CFTC’s proposed business conduct standards have not yet been finalized.

The Proposed Rules will be published in the Federal Register in the coming days, but a pre-publication copy of the Proposed Rules is available [here](#). The public comment deadline for the Proposed Rules is August 29, 2011.

The Proposed Rules

Pursuant to the Proposed Rules, a security-based swap dealer or major security-based swap participant, when entering into a security-based swap, will be required to, among other things:

- Communicate with its counterparty in a fair and balanced manner based on principles of good faith and fair dealing;
- Verify whether its counterparty is an eligible contract participant or a “special entity” (defined below);
- Disclose material information about the security-based swap to its counterparty, including the security-based swap’s characteristics and material risks, as well as the security-based swap dealer’s or major security-based swap participant’s incentives and conflicts of interest;
- Provide its counterparty with information about the daily mark of the security-based swap;
- Provide its counterparty with information regarding the ability to clear the security-based swap;
- Establish a supervisory and compliance infrastructure;

¹ See Sutherland’s Title VII Regulatory Roadmap, available [here](#). The Dodd-Frank Act gave the SEC jurisdiction over security-based swaps and the CFTC jurisdiction over swaps. The CFTC’s proposed business conduct standards will only apply to swap dealers and major swap participants engaging in swaps.

- Designate a chief compliance officer that will, among other things, create an annual compliance report;
- Determine that any recommendations made regarding security-based swaps are suitable for its counterparty;
- Establish, maintain and enforce policies and procedures reasonably designed to obtain and retain a record of the “essential facts” (as defined in the Proposed Rules) that are necessary for conducting business with each counterparty (only applicable to security-based swap dealers); and
- Comply with “pay-to-play” restrictions that prohibit security-based swap transactions with a municipal entity if certain political contributions have been made to officials of the municipal entity (only applicable to security-based swap dealers).

Treatment of Special Entities

The Proposed Rules offer enhanced protections to “special entities” engaging in security-based swaps with security-based swap dealers or major security-based swap participants. “Special entities” include federal agencies, states and their political subdivisions, employee benefit plans as defined under the Employment Retirement Income Security Act of 1974 (ERISA), governmental plans as defined under ERISA, and endowments.²

When serving as a counterparty to a security-based swap with a special entity, a security-based swap dealer or major security-based swap participant must reasonably believe that the special entity has an independent representative that:

- Has sufficient knowledge to evaluate the transaction and risks;
- Is not subject to a statutory disqualification;
- Is independent of the security-based swap dealer or major security-based swap participant;
- Undertakes a duty to act in the best interests of the special entity;
- Makes appropriate disclosures of material information concerning the security-based swap; and
- Provides written representations to the special entity regarding fair pricing and appropriateness of the security-based swap.

Further, if the security-based swap dealer or major security-based swap participant is serving as an “advisor” to the special entity, the security-based swap dealer or major security-based swap participant must act in the best interests of the special entity and undertake reasonable efforts to obtain such information as is necessary to make a reasonable determination that a recommended security-based swap is in the best interests of the special entity.

² See § 764(a) of the Dodd-Frank Act.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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