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## CFTC Adopts Registration Rules and External Business Conduct Standards for Swap Dealers and Major Swap Participants

**The Commodity Futures Trading Commission (“CFTC”) recently adopted a series of rules and orders that begin to establish the final framework for the registration and regulation of swap dealers (“Dealers”) and major swap participants (“MSPs”, and together with Dealers, “Registered Entities”). On January 11, 2012, the CFTC adopted Registration Rules (the “Registration Rules”) to implement new Registered Entity registration requirements under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”)<sup>1</sup>. The CFTC also authorized the National Futures Association (“NFA”) to administer the registration process for Registered Entities (the “Order”)<sup>2</sup>. The CFTC, in a divided vote, separately adopted the first set of business conduct standards to apply to Registered Entities—the so-called “external” business conduct rules (the “External Business Conduct Rules”)<sup>3</sup>.**

The Registration Rules and the Order together establish the procedures for registration of Dealers and MSPs. However, as acknowledged in the Registration Rules, several significant substantive issues for Registered Entities

<sup>1</sup> Registration of Swap Dealers and Major Swap Participants (Final Rule), 77 Fed. Reg. 2613 (Jan. 19, 2012) (to be codified at 17 C.F.R. pts. 1.3, 23, and 170).

<sup>2</sup> Performance of Registration Functions by National Futures Association With Respect to Swap Dealers and Major Swap Participants (Delegation of Authority Order), 77 Fed. Reg. 2708 (Jan. 19, 2012).

<sup>3</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties (Final Rule), (January 11, 2012), available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112e.pdf> (last visited January 25, 2012).

remain to be addressed. These include, among others, (1) the definitions of Dealer and MSP (i.e., who is required to register), (2) many of the key regulatory requirements that will apply to Registered Entities and (3) the application of the Dealer and MSP requirements to entities outside the United States. As a result, the full scope of the regulatory requirements for Registered Entities is not yet clear.

Pending completion of the regulatory framework, entities that expect that they will be Registered Entities will be able to provisionally register with the NFA and demonstrate compliance with a number of the new requirements applicable to Registered Entities on a rolling basis as they become effective. Registration will be required by the latest effective date of the final rules defining Dealer and MSP. The NFA began accepting applications through its electronic registration system on January 19, 2012<sup>4</sup>. Registered Dealers and MSPs will be required to be NFA members as well.

As a result of the External Business Conduct Rules, Registered Entities will have a substantially expanded set of obligations towards their counterparties than they have had in the current OTC derivatives market. Following the compliance date of the External Business Conduct Rules<sup>5</sup>, Registered Entities will be required, among other things, to provide enhanced disclosure of material information to counterparties and will have suitability obligations when recommending swap transactions. These types of enhanced responsibilities are expected to fundamentally alter the current business and trading relationship between derivatives dealers and their clients. As discussed in more detail below, not all of these new requirements are applicable to MSPs and some additional requirements are applicable only when dealing with so-called “Special Entities”, which include among others, US federal or state governmental agencies, employee benefit plans subject to Title I of the Employee Retirement Income Security Act of 1974 (“ERISA” and “ERISA Plans”, respectively), governmental plans (as defined in Section 3 of ERISA) and endowments.

## The Registration Process

### Procedures for Registration

Pursuant to the Order, the NFA will administer the registration process. Registration is accomplished by submitting to the NFA a Form 7-R for the applicant and a Form 8-R<sup>6</sup> and fingerprint cards for the principals of the applicant<sup>7</sup>. Unlike the process for registration of FCMs and other CFTC registrants, Registered Entity applicants will also have to submit documentation demonstrating compliance (or, if applicable, ability to comply) with the

<sup>4</sup> National Futures Association: Swaps Information, <http://www.nfa.futures.org> (last visited January 25, 2012).

<sup>5</sup> The compliance date is the later of either the registration deadline for Registered Entities or 180 days after the effective date which is 60 days after the final rule is published in the Federal Register.

<sup>6</sup> Form 7-R and Form 8-R require disclosure of information about the applicant, including any criminal sanctions or regulatory actions that an entity or person may have been subject to.

<sup>7</sup> Principals include officers, directors and persons who own 10 percent or more of the outstanding shares of the applicant or registrant.

various requirements for Registered Entities under Section 4s of the Commodity Exchange Act (the “4s Requirements”), which will include requirements with respect to, among other things, capital and margin, reporting and recordkeeping, daily trading records, business conduct standards (including the External Business Conduct Rules), documentation standards, trading duties, designation of a chief compliance officer, and, with respect to uncleared swaps, segregation of customer funds. Upon provisional registration, Registered Entities will become subject to any effective 4s Requirements<sup>8</sup>. Applicants will also be subject to the CFTC’s authority to conduct on-site inspections. Registered Entities will be required to promptly correct any deficiencies or inaccuracies on their registration materials and update their filed registration materials on an annual basis as determined by the NFA.

### Associated Persons

Associated persons of Registered Entities—natural persons who solicit or supervise those who solicit the entry into swaps on behalf of Registered Entities—are not themselves required to register with the CFTC or NFA (unlike associated persons for FCMs and other CFTC registrants). Nonetheless, Registered Entities are prohibited from permitting an associated person to be involved with effecting swaps if that person is subject to a statutory disqualification under Section 8a(2) or 8a(3) of the CEA. Sections 8a(2) and 8a(3) of the CEA contain an extensive list of disqualifications, including felony convictions, commodities or securities law violations, and bans or other adverse actions taken by financial regulators. However, if a person who is subject to a statutory disqualification has been permitted to register as a principal or associate of another registrant (e.g., futures commission merchant, commodity pool operator or commodity trading advisor), then the disqualification would not bar that person’s association with a Registered Entity.

### Provisional Registration and Rolling Compliance with 4s Requirements

After the applicant applies to the NFA, the applicant will be granted provisional registration, provided that the Registration Rules have become effective<sup>9</sup>, and subject to completion of a fitness review by the NFA to determine if the applicant has demonstrated compliance with the 4s Requirements effective at the time of application. 4s Requirements may have delayed compliance deadlines, and applicants must therefore review the specific deadline established for each 4s Requirement. For those applicants beginning the application process prior to the effective date of the Registration Rules (March 19, 2012), the NFA has requested that Registered Entities refrain from

<sup>8</sup> The NFA will not require applicants to demonstrate compliance with any 4s Requirements until the effectiveness of the Registration Rules on March 19, 2012, which is 60 days after publication of the Registration Rules in the Federal Register. See National Futures Association: Swaps Registration Overview, <http://www.nfa.futures.org/NFA-swaps-information/swaps-registration-overview.HTML>, (last visited January 25, 2012).

<sup>9</sup> While the NFA began accepting applications on January 19, 2012, applicants cannot be deemed provisionally registered until the effective date of the Registration Rules.

submitting documentation demonstrating compliance with any 4s Requirements until March 19, 2012<sup>10</sup>. The NFA will then either provide confirmation of initial compliance or, if an applicant fails to satisfactorily demonstrate compliance with effective 4s Requirements, may issue a notice of deficiency. Unless the applicant is able to cure the deficiency within a 90-day cure period, the applicant must withdraw its application and not engage in any new activity as a Dealer or MSP. The CFTC has the discretion to extend this 90-day cure period upon request from the applicant. Applicants who have provisionally registered must also demonstrate compliance with each newly finalized 4s Requirement on a rolling basis as it becomes effective and are subject to the same consequence for a failure to comply. A Registered Entity that provisionally registers will automatically become fully registered after all of the final rules defining Dealer and MSP and 4s Requirements become effective and such entity demonstrates compliance with all 4s Requirements.

### External Business Conduct Standards

The CFTC also adopted the External Business Conduct Rules, which establish business conduct standards under CEA section 4s(h) governing the conduct of Registered Entities in dealing with their counterparties in entering into swaps. The CFTC is expected to separately consider “internal” business conduct standards addressing various aspects of a Registered Entity’s internal operations in the coming months.

The External Business Conduct Rules represent a significant change in the manner in which swap market participants have dealt with their counterparties, which historically has been on a “non-reliance” basis in which a market participant undertakes few, if any, specific duties with respect to a counterparty. Following effectiveness of the External Business Conduct Rules, Registered Entities will be subject to strict and detailed business conduct standards in dealing with their swap clients generally. Nonetheless, the final External Business Conduct Rules have been scaled back in certain significant respects from the originally proposed rules in response to comment from market participants.

Among other obligations, the External Business Conduct Rules generally require Registered Entities to conduct due diligence on their counterparties to verify eligibility to trade (including eligible contract participant status), refrain from engaging in abusive market practices, provide disclosure of material information about the swap to their counterparties, provide a daily mid-market mark for uncleared swaps and, when recommending a swap to a counterparty, make a determination as to the suitability of the swap for the counterparty based on reasonable diligence concerning the counterparty. Registered Entities are also required to inform their counterparties of their right to (1) clear a swap that is not required to be cleared, (2) select the Derivative Clearing Organization through which a cleared swap would be cleared and (3) request a scenario analysis and a daily mid-market mark for cleared swaps.

<sup>10</sup> See National Futures Association: Swaps Registration Overview, <http://www.nfa.futures.org/NFA-swaps-information/swaps-registration-overview.HTML>, (last visited January 25, 2012).

With respect to disclosure, Registered Entities must provide material information sufficient to allow the counterparty to assess the swap's material risks, characteristics, incentives and conflicts of interests. In addition, for swaps that are not made available for trading on a swap execution facility or designated contract market, Dealers are required, upon request of the counterparty, to provide their counterparty with a scenario analysis that is developed in consultation with the counterparty and that the CFTC recommends be produced in accordance with industry best practices.

In terms of the suitability requirement, the External Business Conduct Rules provide Dealers a safe harbor, where the Dealer reasonably determines that the counterparty (or its agent) is capable of independently evaluating the recommendation, the counterparty (or such agent) represents that it is doing so, and the Dealer discloses in writing that it is not evaluating the suitability of the recommendation and is acting in its capacity as a counterparty, rather than as an advisor.

A key question following the proposed rules had been the treatment of transactions between Registered Entities and Special Entities. Various concerns had been raised that the requirements of the proposed rules could make it effectively impossible to transact with such entities, particularly ERISA Plans, because of the risk of becoming a fiduciary of the Special Entity. Although the External Business Conduct Rules, like Dodd-Frank itself, impose additional requirements for Registered Entities dealing with Special Entities, the final rules include various changes (including a safe harbor) intended to deal with those concerns. Additionally, in a letter to the CFTC dated January 17, 2012, the Department of Labor (the "DOL") concluded that the Registration Rules do not require Registered Entities to engage in any activities that would make them fiduciaries under the 5-part test currently used by the DOL. The DOL has also indicated that it is fully committed to ensuring that any changes to the current 5-part fiduciary test do not result in unintended consequences for Registered Entities.

When a Registered Entity is entering into a swap with a Special Entity as counterparty, the Registered Entity is generally required to make a determination that the Special Entity's representative is independent of the Registered Entity and has sufficient knowledge to evaluate the transaction and risks and, with respect to an ERISA Plan, that the representative is an ERISA fiduciary. Registered Entities are entitled to rely on written representations of the Special Entities, absent knowledge of additional information that would reasonably call into question the accuracy of the representation. The External Business Conduct Rules generally provide Registered Entities a safe harbor with respect to the qualifications of the representative if the Special Entity and the representative represent that they complied with their own policies and procedures reasonably designed to ensure that the representative satisfies the applicable criteria. However, if the Special Entity is an ERISA Plan, then the ERISA Plan must represent in writing that the representative is an ERISA fiduciary. The External Business Conduct Rules also provide Registered Entities a safe harbor with respect to the independence of the representative, if the representative is not affiliated with the Registered Entity, is not under common control with the Registered Entity, does not have an undisclosed conflict of interest with respect to the Registered Entity, or has not been referred to the Special Entity in the past year by the Registered Entity.

The External Business Conduct Rules subject Dealers to heightened duties when acting as an advisor<sup>11</sup> (rather than a counterparty) to a swap with a Special Entity. When a Dealer acting as an advisor to a Special Entity recommends a swap to that Special Entity, the Dealer, in addition to complying with the suitability obligations required when dealing with all counterparties, must also make (i) a reasonable determination that the swap is in the “best interests” of the Special Entity and (ii) reasonable efforts to obtain the information necessary to make that determination. The DOL and the CFTC have concluded that the “best interests” duty does not impose a fiduciary duty upon the Dealer. Rather, the CFTC concluded that a Dealer fulfills its “best interests” duty if the Dealer makes a reasonable effort to obtain necessary information, acts in good faith, employs reasonable care to ensure that the swap recommendation furthers the Special Entity’s stated objectives and discloses all material facts and conflicts with respect to the recommended swap.

There are certain cases in which the External Business Conduct Rules will not apply. In particular, certain of the External Business Conduct Rules will not apply to MSPs, including the counterparty diligence requirement, the suitability requirement and the rules that apply to acting as an advisor to a Special Entity. No obligation to disclose material information about the swap is applicable when a Registered Entity’s counterparty is another Registered Entity. In addition, when a Registered Entity executes a trade on a designated contract market or a swap execution facility where it does not know the identity of its counterparty, then the Registered Entity is generally not required to verify their counterparty’s eligibility or disclose material information about the swap<sup>12</sup>.

The External Business Conduct Rules will become effective 60 days after publication in the Federal Register and compliance is required by the later of 180 days after effectiveness of the External Business Conduct Rules or the registration deadline for Registered Entities.

## Extraterritoriality

Although many market participants have raised concerns about the potential extraterritorial application of the Dealer and MSP registration requirements and regulations, the Registration Rules and External Business Conduct Rules do not address these issues. As a result, potential Registered Entities located outside the United States continue to be subject to uncertainty as to the extent to which they will be subject to these requirements<sup>13</sup>. The CFTC has requested comment on the extraterritorial application of various Dodd-Frank requirements and has said it plans to address the topic in a separate release in the coming months.

<sup>11</sup> A Dealer “acts as 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. However, a Dealer may avoid being deemed to have acted as an advisor by complying with a safe harbor provision that requires, (i) with respect to an ERISA Plan, certain communications between the Dealer and a fiduciary of the ERISA Plan, and, (ii) with respect to any other type of Special Entity, certain communications by the Dealer to the Special Entity.

<sup>12</sup> This suggests that for SEFs operating a request for quote or similar execution methodology where a Registered Entity does know the identity of its counterparty, these requirements will apply.

<sup>13</sup> See Registration of Swap Dealers and Major Swap Participants (Proposed Rule) 75 Fed. Reg. 71382 (Nov. 23, 2010) (“[A] person outside the US who engages in swap dealing activities and regularly enters into swaps with US persons would likely be required to register as a swap dealer.”).

## Delegation of Authority to the National Futures Association

In addition to CFTC regulations, the Registration Rules and the Order establish that all Registered Entities must register and become members of the NFA and therefore become subject to the NFA's own set of rules and regulations. In addition to processing registration applications, the NFA will be responsible for notifying applicants of provisional registration, confirming initial compliance with 4s Requirements, conducting proceedings to revoke registration if necessary and collecting and maintaining records provided by the applicants.

## Conclusion

With the adoption of the Registration Rules, the CFTC has laid out the path to registration, but exactly which entities will be required to register and what rules they will be required to comply with are two important questions that will depend on further regulatory action. It is also important to note that the US Securities and Exchange Commission has not finalized its rules regarding the registration or regulation of Security-Based Swap Dealers and Major Security-Based Swap Participants. We will continue to keep clients updated on any regulatory developments.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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