ALLEN & OVERY

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CFTC Adopts Pay-to-Play Rule for Swap Dealers

Introduction

On January 12, 2012 the Commodity Futures Trading Commission (**CFTC**) adopted its new "pay-to-play" rule (the **Rule**)[1] for swap dealers (**Swap Dealers**)[2] as part of its final regulation imposing business conduct standards on Swap Dealers and major swap participants in their interactions with counterparties.[3] The Rule (i) bans a Swap Dealer from entering into a swap or a trading strategy involving a swap with a state or local government entity for two years if either the Swap Dealer or certain of its officers and employees make particular political contributions to specific candidates or officeholders associated with the government entity; (ii) limits the ability of a Swap Dealer and its covered employees to fundraise on behalf of state or local candidates, officeholders, and political parties; and (iii) places restrictions on whom a Swap Dealer may pay to solicit a state or local government entity to enter into a swap. Similar to the federal pay-to-play rules for municipal securities dealers and investment advisers, the Rule is a strict liability rule and therefore even if a covered employee of a Swap Dealer makes a contribution out of personal funds for entirely personal reasons (*e.g.*, his or her college roommate was the recipient), the contribution could result in the Swap Dealer being banned from engaging in swap activities with a particular government entity for two years.[4]

The Rule is the latest in an increasing number of federal pay-to-play rules regulating the financial services industry, joining the longstanding Municipal Securities Rulemaking Board (**MSRB**) Rule G-37 for municipal securities dealers[5] and the more recent SEC Rule 206(4)-5 for investment advisers.[6] We expect within the year that the SEC, MSRB and Financial Industry Regulatory Authority (**FINRA**) will adopt additional pay-to-play rules for securities-based swap dealers,[7] municipal advisors,[8] and registered broker-dealers engaging in placement agent activities for private funds (**placement agents**),[9] respectively. And these federal pay-to-play developments are in addition to rapidly expanding state and local regulation of government contractors and prospective

government contractors – through, among other things, state and local pay-to-play, procurement lobbying and placement agent regimes – to which Swap Dealers seeking to do business with public entities may already be subject.[10]

Although the Rule becomes effective on April 17, 2012, Swap Dealers have at least until **October 15, 2012** before they become subject to the Rule's restrictions.[11] Swap Dealers should use the intervening period to create and implement comprehensive pay-to-play compliance programs that not only encompass the Rule's requirements, but also incorporate the requirements of any other relevant federal, state or local political regime. In so doing, Swap Dealers would be advised to consider the pay-to-play compliance programs currently being used by municipal dealers and investment advisers covered by rules G-37 and 206(4)-5, respectively. Despite the differences between the various business lines, all three rules employ the same basic regulatory approach and therefore pose similar compliance challenges.

Developing a practical and effective compliance system for the Rule will require each Swap Dealer to take into account a number of individualized factors, including the size and complexity of the Swap Dealer's government-related business, the number of covered employees at the Swap Dealer, and the extent to which the Swap Dealer and its covered employees are politically active. In addition, depending on where its employees are located, a Swap Dealer may need to consider labor law restrictions; several jurisdictions, most notably California, place significant limits on the ability of employers to direct or control their employees' personal political activities.[12] The optimal approach for complying with the Rule therefore will depend on the risk profile of the Swap Dealer, and is likely to range from requiring pre-clearance of all political contributions by covered employees to a complete ban on certain types of employee political activity.

Swap Dealers and their respective compliance teams will need to fully understand when the Rule is implicated in order to avoid accidentally triggering the two-year ban on their swap business or otherwise violating the Rule's restrictions. Below is a roadmap designed to provide preliminary guidance to that effect.

The Rule and Its Two-Year Ban on Swap Business

The Rule prohibits a Swap Dealer from entering into or offering to enter into a swap or a trading strategy involving a swap with certain government entities for two years if (1) either the Swap Dealer or a "**Covered Associate**" of the Swap Dealer (2) makes a "**Contribution**" (3) to an "**Official**" of a "**governmental Special Entity**" (the **Two-Year Ban** or **Ban**). All three of these factors must be present to trigger the Two-Year Ban on swap business.

"COVERED ASSOCIATE"

Similar to most other federal and state pay-to-play rules, the Rule imputes political contributions made by certain employees of a Swap Dealer to the Swap Dealer itself for purposes of the Two-Year Ban. For example, if the CEO of a Swap Dealer makes a Contribution out of his or her personal funds to a candidate for Governor of California, the Swap Dealer may be barred from engaging in swaps business with California state entities for two years.

The Rule, however, does not impute all employee political contributions to the Swap Dealer for purposes of the Two-Year Ban; rather, the Rule's restrictions only apply to those Swap Dealer employees who qualify as Covered Associates under the Rule. The Rule defines a "Covered Associate" as:

- Any general partner, managing member, or executive officer,[13] or other person with a similar status or function – essentially any employee of the Swap Dealer or an affiliate of the Swap Dealer with senior managerial or policymaking responsibility for the Swap Dealer,
- Any employee who solicits a governmental Special Entity for the Swap Dealer and any person who supervises, directly or indirectly, such an employee; and
- Any political action committee (**PAC**) controlled by the Swap Dealer or its Covered Associates.[14]

The Rule also broadly defines "solicitation" as any "direct or indirect communication by any person with a governmental Special Entity for the purpose of obtaining or retaining an engagement related to a Swap."[15] In addition, the Rule defines a "governmental Special Entity" to include any state or municipality, and any political subdivision of a state or municipality. This definition is broad and encompasses public pension systems, ERISA-type pension funds maintained by public entities, and "instrumentalities" or "corporations" sponsored or established by a state or municipality.[16]

Thus, in practice, covered individuals will generally include the Swap Dealer's senior management and any employee who communicates with any state and local government entity to help secure or retain swap business.

"CONTRIBUTION"

The Rule defines a Contribution as "any gift, subscription, loan, advance or deposit of money or anything of value made for the purpose of (1) influencing any election for federal, state, or local office; (2) paying off debt incurred in connection with any election for federal, state, or local office; or (3) paying for inaugural or transition expenses incurred by a successful candidate for federal, state, or local office."[17] The Rule therefore does not regulate the provision of gifts or entertainment by a Swap Dealer to state or local government employees, as a general matter, although such activity may be subject to regulation under state or local gift law.[18]

"OFFICIAL" OF A GOVERNMENTAL SPECIAL ENTITY

The Rule does not restrict all political contributions by Swap Dealers and Covered Associates; rather, the Two-Year Ban is only triggered if the Swap Dealer or Covered Associate makes a Contribution to a covered "Official" of a governmental Special Entity. The Rule defines an Official as any person, who at the time of the contribution, was an incumbent, candidate, or successful candidate *for elective office* of a governmental Special Entity, and such *office* has the authority to either (i) directly or indirectly select or influence the selection of a Swap Dealer by the governmental Special Entity, or (ii) appoint a person who has the authority to directly or indirectly select or influence the selection of a Swap Dealer by the governmental Special Entity.[19]

Thus, in determining who qualifies as an Official for purposes of the Rule, it is the scope of the authority of the office sought or held that determines whether a particular person is a covered official with respect to a specific governmental Special Entity. Even if a particular state or local official in practice may have influence over the selection of a Swap Dealer, he or she is not an Official if

the office he or she holds does not have any formal authority with respect to Swap Dealer selection. The determination of whether a particular candidate is an Official under the Rule therefore requires individualized analysis of the specific office that the recipient of the contribution holds or seeks, although in practice, individuals who hold or seek the office of Governor, Mayor, or Treasurer typically will be covered.

Because the Rule defines Official to include persons who hold an office with the requisite selection or appointive authority as well as persons who are candidates for such an office, state or local officeholders who are running for federal office can qualify as Officials under the Rule. For example, a state Treasurer who runs for the U.S. Senate nonetheless may qualify as an Official because of the authority of his or her present office.

Exceptions And Exemptions To The Two-Year Ban

Although the scope of the Two-Year Ban is broad, the Rule does contain three exceptions to the Ban which partly mitigate its impact: (1) the "**De Minimis Exception**," which permits Covered Associates who are individuals to make relatively modest contributions; (2) the "**Six-Month Look-Back Exception**," which limits the extent to which the Ban can be triggered by contributions made by a Covered Associate before he or she became a Covered Associate; and (3) the "**DCM/SEF Exception**," which excepts any swap initiated on a designated contract market (**DCM**) or swap execution facility (**SEF**) where the Swap Dealer does not know the identity of the counterparty prior to the execution of the Swap from the Ban's reach.[20]

In addition, even if a Swap Dealer initially becomes subject to the Two-Year Ban, it may be able to obtain an exemption from the Ban's application. The Rule provides for a narrow automatic exemption, and also grants the CFTC the discretionary authority to exempt a Swap Dealer from the Ban, upon application, in light of the totality of circumstances surrounding the triggering contribution.

EXCEPTIONS

De Minimis Exception

The Rule allows Covered Associates who are natural persons to make *de minimis* contributions to Officials without triggering the Two-Year Ban. Under the Rule, a Covered Associate may give a candidate who qualifies as an Official up to USD350 per election per candidate if the Covered Associate is entitled to vote for the candidate at the time of the contribution, and may give a candidate who qualifies as an Official up to USD150 per election if the Covered Associate is not entitled to vote for that particular candidate.[21]

Six-Month Look-Back Exception

Consistent with both Rule G-37 and the SEC Investment Adviser Rule, the Rule includes a "look-back" provision pursuant to which Contributions made by a natural person prior to becoming a Covered Associate of a Swap Dealer are nonetheless imputed to the Swap Dealer for purposes of the Two-Year Ban.[22] On its face, the Rule's "look-back" provision extends two years – in other words, a

Swap Dealer potentially can be banned from entering into a swap with a state or local government entity because of a Contribution made by a newly-hired Covered Associate two years earlier.[23]

The Rule, however, includes an exception for Contributions made by a natural person more than six months *before* he or she became a Covered Associate of the Swap Dealer, unless such person solicits a governmental Special Entity that otherwise would be subject to the Two-Year Ban on behalf of the Swap Dealer. This exception effectively shortens the "look-back" timeframe to six months, as long as the Covered Associate in question abides by the solicitation restriction. For example, assume that a newly-hired Covered Associate of a Swap Dealer made a Contribution to an Official of a governmental Special Entity one year prior to being hired by the Swap Dealer. If the Covered Associate does not solicit the same governmental Special Entity for two years from the date of the Contribution, the Swap Dealer will not be subject to the Two-Year Ban. By contrast, if such a solicitation does occur, the exception will not apply and the Swap Dealer will be banned from engaging in swap business with the governmental Special Entity for one year (*i.e.*, two years from the date the Contribution was initially made).

Although the exception mitigates the impact of the two-year look-back provision in cases where a Contribution occurs more than six months before the date the contributor becomes a Covered Associate, Contributions made within the six-month timeframe can have a significant impact on a Swap Dealer's ability to engage in swaps-related business with state and local government entities. Under the Rule, if a Covered Associate makes a contribution to an Official of a governmental Special Entity *within* six months before becoming hired as (or being promoted to) a Covered Associate, that contribution would trigger the Two-Year Ban on business with that governmental Special Entity, irrespective of the Covered Associate's solicitation activities. Thus, as a practical matter, the look-back provision effectively imposes a six-month "garden leave" on new hires (or internal promotions) who have made contributions within six months of becoming a Covered Associate. For example, if a person made a contribution to an Official of a governmental Special Entity two months before becoming a Covered Associate, the Swap Dealer would be banned from engaging in swap business with that governmental Special Entity for 1 year and 10 months, *i.e.*, a total of two years from the date of the contribution, unless any of the other exceptions or exemptions applied.

The "onboarding" of new Covered Associates – either through new hires or internal promotions – is typically one of the more problematic compliance issues for financial institutions subject to a federal pay-to-play regime. Many of the exemption requests filed in connection with Rule G-37 (discussed in more detail below) have involved "onboarding" errors in which a political contribution made by an individual prior to assuming covered status was only discovered after the individual already had become a Covered Associate. At a minimum, Swap Dealers must implement effective screening procedures designed to identify any Contributions made by a potential Covered Associate before the person assumes Covered Associate status. If Compliance identifies potential Contributions during the screening process for a potential Covered Associate, the "onboarding" process should be halted until Compliance is able to determine whether and to what extent the Two-Year Ban may be implicated.

DCM/SEF Exception

Finally, even if a Swap Dealer is subject to the Two-Year Ban with respect to a particular governmental Special Entity, the Rule permits the Swap Dealer to enter into a swap with that governmental Special Entity as long as (i) the swap is initiated on a DCM or SEF and (ii) the Swap Dealer does not know that the governmental Special Entity is the counterparty prior to execution.[24] The applicability of this exception will depend on the method selected by the governmental Special Entity to enter into the swap. Market participants can enter into swaps on a SEF through a book order model or a request for quotes (**RFQ**) model. The book order model, used by most exchanges, matches automatically requests from market participants. Under the

RFQ model, one market participant requests quotes to enter into a particular contract and other participants submit offers to meet the query. The RFQ model may be used more frequently for less liquid contracts where there isn't automatically an offer sitting ready to be accepted on the platform.

Though there is no certainty as to the actual operation of SEFs because no SEF is operational at this time, we expect most SEFs to offer both a book order model and an RFQ model. Under the book order model, the parties are able to preserve their anonymity as requests can be submitted to the platform without the identity of the counterparty being revealed. In this case, the exception will apply. However, if a governmental Special Entity chooses to request a quote, the identity of the requestor and, especially the identities of the requestees, will be known to each other. As a result, the exception would likely not apply in this case.

EXEMPTIONS

Automatic Exemption from the Two-Year Ban

The Rule provides for an automatic exemption when three factors are present: (1) a Swap Dealer discovers a Contribution made by a natural person Covered Associate within 120 calendar days of the date the contribution was made; (2) the Contribution amount did not exceed the USD350 or USD150 thresholds as set out by the De Minimis Exception; and (3) the Covered Associate obtained a return of the Contribution within 60 calendar days of the date of the discovery of the Contribution by the Swap Dealer.[25] It should be noted that a Swap Dealer neither can rely on this exemption more than twice in any 12 month period nor use it more than once for any Covered Associate during his or her employment with the Swap Dealer.[26]

In what is likely an unintended departure from the SEC Investment Adviser Rule, on its face the second factor of the Rule's automatic exemption appears to render the exemption a nullity – a Contribution that does not exceed the *de minimis* thresholds by definition will never trigger the Two-Year Ban and therefore will never give rise to the need for an automatic exemption. We are assuming that this was an oversight by the CFTC and that the automatic exemption is meant to function in similar fashion to the SEC Investment Adviser Rule's automatic exemption. Under the SEC Investment Adviser Rule, the second factor for the automatic exemption requires that the contribution in question not exceed USD350. This permits covered persons under the SEC Investment Adviser Rule to potentially qualify for the automatic exemption if they make contributions of more than USD150 but less than USD350 to candidates for whom they cannot vote.[27]

Exemption from the Two-Year Ban at the CFTC's Discretion

The Rule also provides the CFTC with the discretion, upon receipt of an application from a Swap Dealer, to exempt, conditionally or unconditionally, the Swap Dealer from the Two-Year Ban in light of the totality of circumstances surrounding the contribution giving rise to the prohibition. Although the Rule does not limit the factors that the CFTC may consider in addressing such an application, the Rule lists six non-exclusive factors that the CFTC will consider in reviewing such a request: (1) whether the exemption is necessary or appropriate in the public interest; (2) whether the Swap Dealer had implemented policies and procedures designed to prevent against violation prior to the contribution in question being made, had actual knowledge of the contribution at the time it was made and, after learning of the contribution, took all appropriate remedial measures in light of the circumstances, including taking available steps to obtain return of the contribution; (3) whether the contributor in question was an employee of the Swap Dealer or seeking employment with the Swap Dealer at the time of the contribution; (4) the timing and the amount of the contribution in question; (5) the nature of the election (*e.g.*, federal, state or local); and (6) the

contributor's apparent intent and motive behind making the contribution in question, as evidenced by the facts and circumstances surrounding the Contribution.[28]

While neither the Rule nor the release provide meaningful guidance on how the CFTC or the National Futures Association (**NFA**)[29] is likely to exercise the authority to grant exemptions, the CFTC's discretion under the Rule is similar to the discretionary exemption authority exercised by FINRA with respect to Rule G-37. If the CFTC takes a similar approach to discretionary exemptions to that of FINRA under Rule G-37, then it is likely that such requests will be granted sparingly and only when all of the foregoing requirements are met. Indeed, over the past three years, only five exemptions have been granted from the application of rule G-37 by FINRA's National Adjudicatory Council (**NAC**). In each case when the NAC has granted an exemption, it cited the following reasons: (1) at the time of making the Contribution, the individual was not a municipal finance professional (the equivalent of a Covered Associate); (2) the soliciting entity and the governmental Special Entity had a pre-existing relationship prior to the Covered Associate joining; (3) the existence of information barriers within the soliciting entity; and (4) the Covered Associate was prohibited from soliciting new business from certain governmental Special Entities for a certain period of time.[30]

Additional Express Prohibitions Under The Rule

In addition to the Two-Year Ban, the Rule includes two other restrictions on Swap Dealer and Covered Associate political activity: (i) a prohibition on Swap Dealers and Covered Associates fundraising on behalf of Officials or certain state or local political parties; and (ii) a prohibition on Swap Dealers and Covered Associates compensating a party to solicit a governmental Special Entity to enter into a swap unless that party is a "**Regulated Person**." The penalties associated with these provisions, however, do not trigger the Two-Year Ban – rather, violating one of these prohibitions will merely subject a Swap Dealer to the general civil penalties for Commodities Exchange Act (**CEA**) violations.

ANTI-COORDINATION AND SOLICITATION ("BUNDLING") PROVISIONS

In addition to restricting the ability of Swap Dealers and Covered Associates to make Contributions to Officials, the Rule also prohibits Swap Dealers and Covered Associates from soliciting Contributions for such Officials from third parties and from fundraising on behalf of state or local political parties that might support such Officials' campaigns.

Under the Rule, Swap Dealers and Covered Associates are prohibited from coordinating or soliciting any person or PAC to (1) make a Contribution to an Official of a governmental Special Entity with which the Swap Dealer either has entered into or offered to enter into a swap, or (2) make a "**Payment**" to a state or local political party of the jurisdiction with which the Swap Dealer either has entered into or offered to enter into a swap.[31] The Rule defines "payment" as "any gift, subscription, loan, advance, or deposit of money, or anything of value" and – in contrast to a Contribution – does not require a nexus between the payment and an election or

transition/inauguration.[32] The Rule therefore prohibits Swap Dealers and Covered Associates from engaging in any fundraising on behalf of covered state and local political parties, regardless of whether that fundraising is connected to a particular campaign or election.

Thus, in developing their compliance program for the Rule, Swap Dealers will need to incorporate mechanisms for monitoring Covered Associate fundraising as well as Covered Associate contributions.

ONLY REGULATED PERSONS CAN BE PAID TO SOLICIT ON BEHALF OF THE SWAP DEALER

The Rule also regulates the ability of a Swap Dealer to solicit a governmental Special Entity to enter into a swap. The Rule prohibits Swap Dealers or Covered Associates from "[p]rovid[ing] or agree[ing] to provide, directly or indirectly, payment to any person to solicit a governmental Special Entity" to enter into a swap with the Swap Dealer unless that person is a Regulated Person.[33] The Rule further defines Regulated Person as (i) a person or entity that is subject to a federal pay-to-play law imposed by the SEC, the CFTC, or a self-regulatory organization subject to the jurisdiction of the SEC or CFTC; and (ii) any employee of such a person or entity who (a) serves in a senior managerial capacity or (b) solicits a governmental Special Entity on behalf of the Swap Dealer or supervises a person who so solicits.[34]

In practice, a Swap Dealer can comply with this prohibition by either using its own employees to solicit governmental Special Entities or using third parties (such as a registered broker-dealer or Swap Dealer) who are subject to a federal pay-to-play rule.

Anti-Circumvention Provision

The Rule includes an anti-circumvention provision that prohibits a Swap Dealer and its Covered Associates from doing indirectly what they cannot do directly. This provision prevents Swap Dealers and Covered Associates from evading the Rule's restrictions by using third-party organizations, friends, or family members to make Contributions to or fundraise on behalf of officials.[35]

Analogous anti-circumvention provisions under Rule G-37 and Rule 206(4)-5 have created significant compliance challenges for municipal securities dealers and investment advisers, respectively. Although a regulator would need to show a specific intent to circumvent a restriction to establish a violation of the anti-circumvention provision under Rule G-37 or Rule 206(4)-5 (*i.e.*, circumvention by definition is intentional – a party cannot accidentally circumvent a restriction), FINRA and the SEC frequently scrutinize campaign contributions associated with covered persons to see if such contributions are being funneled or "conduited" to covered officials. In particular, FINRA and the SEC often examine or investigate two types of contributions for potential circumvention: (i) contributions made to covered officials by the spouse or minor children of a covered person; and (ii) contributions made by covered persons to PACs that contribute to covered officials. Accordingly, to protect against this examination/investigation risk, many municipal securities dealers and investment advisers incorporate review and diligence of spousal contributions and PAC contributions into their pay-to-play compliance framework.

Policies & Procedures

The Rule does not impose recordkeeping requirements particular to the pay-to-play aspect of the Business Conduct Rule but imposes general requirements for Swap Dealers in this arena.[36] The Business Conduct Rule mandates *written* policies and procedures "reasonably" designed to ensure compliance with all aspects of the Business Conduct Rule, including the Rule. Such record of compliance should reflect the actions taken to ensure that contributions are not made by Covered Associates to Officials of governmental Special Entities, and also ensure that those policies prevent evasion from the rules. Swap Dealers must implement and monitor these policies as part of their general supervision and risk management program.

Conclusion/Compliance Recommendations

Given the potentially severe consequences of implicating the Two-Year Ban or directly violating the Rule, implementing a robust pay-to-play compliance program is required. Such programs can involve:

- Identifying and "ringfencing" the pool of Covered Associates. All other employees will not be subject to the Rule which can help with the more efficient allocation of compliance resources;
- Creating a compliance program tailored to the size of the pool of Covered Associates and their business and political activities. Swap Dealers may want to borrow from the experiences and the procedures of their municipal dealer and investment adviser counterparts, who have already established pay-to-play procedures under Rules G-37 and 206(4)-5, respectively;
- Developing robust pre-clearance procedures for political contributions, political fundraising, and related political activities;
- Modifying "onboarding" procedures for newly hired or promoted Covered Associates to determine prior political contributions before such person assumes covered status;
- Establishing a strong and focused training program for Covered Associates, both when they are hired and on an annual basis. Election season reminders are also an important part of a good compliance program;
- Hiring sufficient staff and resources to implement effective pre-clearance and training;
- Implementing due diligence procedures to prevent conduiting.

In addition, it is important to recognize that corporate political contributions and employee political activity can create significant reputational and optical risk for Swap Dealers, even in cases whether there is no legal liability. (See "The Growing Use of Corporate Governance to Regulate Corporate Political Activity," Allen & Overy Insight, Nov. 11, 2011.) It is therefore important to establish strong oversight and internal controls for all Swap Dealer and Covered Associate political activities.

Key Contacts

If you wish to speak with us about the matters raised in this document, please call either of the individuals listed below or your usual contact at Allen & Overy.

Barbara Stettner

Partner
Financial Services Regulatory
Tel +1 202 683 3850
barbara.stettner@allenovery.com

Charles Borden

Partner
Financial Services Regulatory
Tel +1 202 683 3852
charles.borden@allenovery.com

Douglas Landy

Partner
Financial Services Regulatory
Tel +1 212 610 6405
douglas.landy@allenovery.com

Bill Satchell

Partner
Financial Services Regulatory
Tel +1 202 683 3860
william.satchell@allenovery.com

David Lucking

Partner
Derivatives and Structured Finance
Tel +1 212 756 1157
david.lucking@allenovery.com

John Williams

Partner
Derivatives and Structured Finance
Tel +1 212 756 1131
john.williams@allenovery.com

Deborah North

Partner
Derivatives and Structured Finance
Tel +1 212 610 6408
deborah.north@allenovery.com

Jason Abel

Associate
Financial Services Regulatory
Tel +1 202 683 3856
jason.abel@allenovery.com

Rachel Loko

Associate
Derivatives and Structured Finance
Tel +1 212 610 6437
rachel.loko@allenovery.com

Sam Brown

Associate
Financial Services Regulatory
Tel +1 202 683 3857
samuel.c.brown@allenovery.com

Endnotes

[1] 17 C.F.R. 23.451; 77 Fed. Reg. 9734, 9827.

[2] The definition of Swap Dealer remains uncertain. Section 712(d) of The Wall Street Reform and Consumer Protection Act of 2010 (**Dodd-Frank Act**) requires the CFTC and the Securities and Exchange Commission (**SEC**) to jointly further define the term "Swap Dealer." While the CFTC and SEC have initiated a joint rulemaking which proposes to clarify the definition of Swap Dealer, such joint rulemaking has yet to be finalized. The Rule will apply to any party that satisfies the definition of a Swap Dealer pursuant to that joint rulemaking. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80174, (proposed, December 21, 2010) (to be codified at 17 C.F.R. pt. 240). Swap Dealer is defined under the Dodd-Frank Act as "any person who:

(i) holds itself out as a dealer in swaps pursuant to Section 1a(49) of the Commodity Exchange Act;

(ii) makes a market in swaps;

(iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or

(iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer."

Commodity Exchange Act, § 7 U.S.C. 1A(49) (1936) (as modified by § 721 of the Dodd-Frank Act).

[3] *See* Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 77 Fed. Reg. 9734, (February 17, 2012) (to be codified at 17 C.F.R. pt. 4 and 23) (the **Business Conduct Rule**). While the broader Business Conduct Rule sets standards for Swap Dealers and major swap participants, this note solely focuses on the pay-to-play restrictions placed on Swap Dealers.

[4] Notably, the CFTC, consistent with the SEC's approach in its proposed pay-to-play rule for security-based swap dealers, departed from its initial proposal and did not make major swap participants subject to the final Rule. *See* Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties; 75 Fed. Reg. 80638 (Proposed, December 22, 2010) (to be codified at 17 C.F.R. pt. 23 and 155). Both agencies reasoned that major swap participants were unlikely to give rise to significant pay-to-play concerns, as they would not "solicit swap transaction business within the meaning of the final rule and as such" would not "assume a dealer-type role in the [swap] market." Rule release at 9800; Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 76 Fed. Reg. 42396, 42433 (Proposed, July 18, 2011) (to be codified at 17 C.F.R. pt. 240), (the **SEC Business Conduct Standard Proposed Rule**).

[5] *See* Political Contributions and Prohibitions on Municipal Securities Business, Rule G-37 (Municipal Securities Rulemaking Board April 25, 1994).

[6] *See* Political Contributions by Certain Investment Advisers, 75 Fed. Reg. 41018, (July 14, 2010) (to be codified at 17 C.F.R. pt. 275) (the **SEC Investment Adviser Rule** or **Rule 206(4)-5**).

[7] *See* SEC Business Conduct Standard Proposed Rule, 76 Fed. Reg. 42396.

[8] *See* Notice of Filing of Proposed New Rule G–42, on Political Contributions and Prohibitions on Municipal Advisory Activities; proposed Amendments to Rules G–8, on Books and Records, G–9, on Preservation of Records, and G–37, on Political Contributions and Prohibitions on Municipal Securities Business; Proposed Form G–37/G–42 and Form G–37x/G–42x; and a Proposed Restatement of a Rule G–37; Interpretive Notice, 76 Fed. Reg. 55976, (Proposed, September 9, 2011). The MSRB withdrew several pending municipal advisor rule proposals so that the SEC could issue a final rule defining "municipal advisor." See MSRB Notice 2011-51 (September 12, 2011).

[9] Under the SEC Investment Adviser Rule, a covered adviser may only pay a party to solicit a government entity to invest in a fund advised by the covered adviser if the soliciting party is a "regulated person" that is "subject to the pay-to-play restrictions either under the [SEC Investment Adviser Rule] or the rules of a registered national securities association [such as FINRA]." Absent an exemption, the Securities Exchange Act of 1934 requires that only registered placement agents be used to solicit any investor, including a government entity, to enter into such a transaction. *See* Section 15(a)(1) of the Securities Exchange Act of 1934; 15 U.S.C. § 78(o)(a)(1). The SEC has indicated that it expects FINRA to issue a pay-to-play rule for placement agents. SEC Investment Adviser Rule, 75 Fed. Reg. 41018, 41042.

[10] At present, more than a dozen states, most major municipalities, and many major public pension systems have their own pay-to-play regimes. *See, e.g.*, 30 Ill. Comp. Stat. 500/50-37 (imposing a pay-to-play regime on all parties who seek or hold contracts worth more than USD50,000 on an annual basis with Illinois state entities); N.Y. Legis. Law § 1-c(c)(v) (defining lobbying to include any attempt to influence "any determination . . . related to a government procurement"); N.Y.C. Adm. Code § 3-702(20) (imposing a pay-to-play regime on all entities that do business or seek to do business with New York City); Cal. Code Regs. tit. 5, § 24010 (imposing a pay-to-play regime on parties seeking to be engaged by the California State Teachers' Retirement System (**CalSTRS**) to certain officials of CalSTRS).

[11] The Rule requires compliance by the later of October 15, 2012 or the date on which entities will be required to register as Swap Dealers with the National Futures Association (60 days after the final rules defining Swap Dealer and major swap participants, yet to be adopted).

[12] *See, e.g.*, Cal. Lab. Code § 1101 (prohibiting an employer from making, adopting or enforcing any rule, regulation or policy that, among other things, "control[s] or direct[s], or tend[s] to control or direct the political activities or affiliations of employees").

[13] The Rule does not define "executive officer." However, because the Rule was largely based on the SEC Investment Adviser Rule, it would be reasonable to presume that similarly situated individuals within the Swap Dealer would be considered executive officers and therefore Covered Associates for purposes of the Rule. *See* 77 Fed. Reg. 9734, 9800. The SEC Investment Adviser Rule defines "executive officer" to include (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 investment adviser who performs a policy-making function; or (iv) any other person who performs similar policy-making functions for the investment adviser. 17 C.F.R. § 275.206(4)-5(f)(4).

[14] 17 C.F.R. § 23.451(a)(2).

[15] 17 C.F.R. § 23.451(a)(7).

[16] 17 C.F.R. § 23.451(a)(3) (citing 23.401(2), (4)).

[17] 17 C.F.R. § 23.451(a)(1).

[18] Virtually every state and local entity imposes restrictions on the ability of public employees to accept gifts and entertainment. *See, e.g.*, N.Y. Pub. Off. Law § 73(5) (prohibiting state employees and officials from accepting any gift having more than a nominal value from a disqualified source); "CalPERS Gift Policy (Revised – 11/09)," California Public Employees' Retirement System, *available at* http://www.calpers.ca.gov/eip-docs/utilities/contact/ethics/calpers_gift_policy.pdf (Nov. 17, 2009) (prohibiting CalPERS employees from accepting anything of value from a person or entity who 1) does business, seeks to do business, or is the type of entity that does business with CalPERS; 2) is regulated or controlled by CalPERS; or 3) is a registered lobbyist, lobbying firm, association, business or interest group who advocate for or against legislation).

[19] 17 C.F.R. § 23.451(a)(4).

[20] 17 C.F.R. § 23.451(b)(2):

> (2) This prohibition does not apply:
>
> (i) If the only contributions made by the swap dealer to an official of such governmental Special Entity were made by a covered associate:
>
> (A) To officials for whom the covered associate was entitled to vote at the time of the contributions, provided that 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, provided that the contributions in the aggregate do not exceed $150 to any one official, per election;
>
> (ii) To a 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 swap dealer, provided that this exclusion shall not apply if the natural person, after becoming a covered associate, solicits the governmental Special Entity on behalf of the swap dealer to offer to enter into or to enter into a swap or trading strategy involving a swap; or
>
> (iii) to a swap that is:
>
> (A) Initiated on a designated contract market or swap execution facility; and
>
> (B) One in which the swap dealer does not know the identity of the counterparty to the transaction prior to execution.

[21] 17 C.F.R. § 23.451(b)(2)(i)(A), (B). These limits are identical to the SEC's *de minimis* exception to the pay-to-play rule for investment advisers. See SEC Investment Adviser Rule release, 75 Fed. Reg. 41018, 41069, 17 C.F.R. 275.206(4)–5(b)(1).

[22] *See* Rule G-37(b)(ii), (iii); 17 C.F.R. § 275.206(4)-5(a)(1).

[23] The look-back applies to all new Covered Associates, regardless of whether they were previously employed by the Swap Dealer. The same analysis therefore applies to existing employees of the Swap Dealer who become Covered Associates through a promotion or other internal reassignment or transfer.

[24] 17 C.F.R. § 23.451(b)(2)(iii).

[25] 17 C.F.R. § 23.451(e)(1).

[26] 17 C.F.R. § 23.451(e)(2), (3).

[27] 17 C.F.R. § 275.206(4)-5(b)(3)(i)(B).

[28] 17 C.F.R. § 23.451(d)(1)-(6).

[29] It is unclear at this point whether the CFTC or the NFA will be responsible for resolving exemption requests.

[30] NAC Exemptive Letters granting relief from Political Contributions and Prohibitions on Municipal Securities Business- MSRB Rule G-37, June 27, 2011, the letter is available at http://www.finra.org/Industry/Regulation/Guidance/ExemptiveLetters/P123915; September 7, 2010, the letter is available at http://www.finra.org/Industry/Regulation/Guidance/ExemptiveLetters/P123851; June 2010, the letter is available at http://www.finra.org/Industry/Regulation/Guidance/ExemptiveLetters/P123837; June 10, 2009, the letter is available at http://www.finra.org/Industry/Regulation/Guidance/ExemptiveLetters/P123844; April 3, 2009, the letter is available at http://www.finra.org/Industry/Regulation/Guidance/ExemptiveLetters/P123835. NAC Exemptive Letters denying relief from Political Contributions and Prohibitions on Municipal Securities Business- MSRB Rule G-37, January 29, 2002, the letter is available at

http://www.finra.org/Industry/Regulation/Guidance/ExemptiveLetters/P002649; March 10, 1997, the letter is available at http://www.finra.org/Industry/Regulation/Guidance/ExemptiveLetters/P002663.

[31] 17 C.F.R. § 23.451(b)(3)(ii).

[32] 17 C.F.R. § 23.451(a)(5).

[33] 17 C.F.R. § 23.451(b)(3)(i).

[34] 17 C.F.R. § 23.451(a)(6).

[35] "No 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 (b) of this section." 17 C.F.R. § 23.451(c).

[36] 17 C.F.R. § 23.402.