October 22, 2010

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Re: Business Conduct Standards

Dear Ms. Murphy and Mr. Stawick:

The Securities Industry and Financial Markets Association ("SIFMA")[1] and the International Swaps and Derivatives Association, Inc. ("ISDA")[2] welcome the opportunity to provide the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC" and, together with the SEC, the "Commissions") with preliminary comments regarding the implementation of certain of the business conduct standards applicable to swap/security-based swap dealers (collectively, "Dealers") and major swap/security-based swap participants (collectively, "MSPs") under the Dodd-Frank Wall Street Reform and Consumer Protection Act

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] ISDA was chartered in 1985 and has over 830 member institutions from 57 countries on six continents. Our members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For more information, visit www.isda.org.

("Dodd-Frank") in anticipation of proposed rulemakings by the Commissions.[3] SIFMA and ISDA appreciate the Commissions' efforts to follow an open and transparent process in connection with their respective rulemakings under Dodd-Frank. SIFMA and ISDA look forward to continuing an open dialogue with the Commissions and their staff during the rulemaking process.

I. Executive Summary

As described in greater detail below, SIFMA and ISDA urge the Commissions to consider the following recommendations in connection with the proposal and adoption of business conduct standards for Dealers and MSPs:

- ***Special Entities.*** The Commissions should clarify the scope of entities that qualify as "Special Entities" by (a) confirming that collective investment vehicles do not become "Special Entities" merely as a result of the investment by Special Entities in such vehicles and (b) specifying that plans not subject to the Employee Retirement Income Security Act of 1974 ("ERISA") (unless they are covered by another applicable prong of the "Special Entity" definition (e.g., governmental plans)) are not "Special Entities."[4] These clarifications will help effectuate Congress' objective of protecting plans in a manner consistent with ERISA.

- ***Advising and Trading with Special Entities.*** It is essential that the Commissions articulate a clear standard for the circumstances that give rise to "advisor" status and the corresponding imposition of the statutory "fiduciary-like" duty to act in the best interests of a Special Entity. Specifically, the Commissions should clarify that, consistent with existing fiduciary standards, such a relationship arises in the context of advisory relationships in which the advisor is granted discretionary authority or in which the advisor is retained in order to provide personalized or tailored advice on which the advisee is expected to rely in making or authorizing an investment decision. A fiduciary-like relationship between two parties is necessarily a function of their expectations, the strongest evidence of which would be the documentation of their relationship. In order to minimize the circumstances in which the parties to a swap[5] proceed based on a misapprehension as to their appropriate expectations and responsibilities, the Commissions should strongly encourage Dealers, MSPs and their Special Entity

[3] This letter elaborates upon a discussion held on August 25, 2010 between members of the Commissions' staff and certain SIFMA representatives and on August 26, 2010 between members of the Commissions' staff and certain ISDA representatives.

[4] On the contrary, master trusts holding the assets of one or more funded plans of a single employer should be considered "Special Entities."

[5] Unless otherwise specified, the term "swap" in this letter is used to mean a "swap," as defined in the Commodity Exchange Act (the "CEA") at Section 1a(47), or a "security-based swap," as defined in the Securities Exchange Act (the "SEA") at Section 3(a)(68). Further, all references herein are to the CEA and SEA as amended by Dodd-Frank.

(indeed, all) counterparties to clearly articulate the nature of their relationship in the documentation governing the transactions between them.

Further, the Commissions should clarify that a Dealer or MSP may, in satisfaction of their obligations under business conduct standards (4)(C) (when acting as an advisor) and (5)(A)(i) (when acting as a counterparty), rely on the representations and information provided to it by a Special Entity or the Special Entity's independent representatives, unless the individual(s) relying on such representations or information know(s) such representations or information are not true.

- ***Disclosure Requirements.*** The Commissions should encourage and sponsor the development and use of standardized disclosure materials regarding material risks, swap characteristics, material incentives and conflicts of interests. Options and futures disclosure statements, and disclosures of the type frequently seen in swap documentation regarding conflicts of interest, provide good precedents for a format of disclosure that would facilitate consistent disclosure practices and quality across the markets. The process of developing standardized disclosure materials would also provide a means for identifying circumstances in which more tailored disclosure might be appropriate and to formulate a framework applicable to such disclosure that would provide clarity and certainty to registrants, and minimize after-the-fact subjective judgments regarding the adequacy of compliance with applicable disclosure standards.

  The Commissions should further clarify, consistent with Dodd-Frank's mandates regarding transaction reporting requirements, that Dealers and MSPs will not be required to disclose specific, non-public transactions, positions or risk profiles to swap counterparties in connection with any mandatory disclosure of material incentives or conflicts of interest.

  The Commissions should additionally clarify that the disclosure requirements (i) can be satisfied by a registrant on a relationship (rather than a transaction-by-transaction) basis in cases where prior disclosures apply to and adequately address the relevant transaction and (ii) do not apply to transactions executed by a registrant on an exchange or a swap execution facility (a "SEF") or otherwise in circumstances where the registrant does not know the identity of its counterparty until immediately prior to (or after) execution.[6]

- ***Daily Marks.*** The Commissions should clarify that the requirement to disclose a "daily mark" for an uncleared swap transaction is intended for the purpose of disclosing, in the context of transactions for which the parties have entered into arrangements for the provision or exchange of margin, the basis for computing

[6] In addition, consideration should be given to the appropriate allocation of responsibilities in the context of give-up transactions involving swaps.

any margin call – and is not intended to impose an obligation on registrants to perform valuation services for their counterparties. Indeed, the Commissions should admonish counterparties not to rely on their Dealer or MSP counterparties for the valuation of outstanding transactions and, instead, to perform their own valuations or utilize independent valuation resources.

Under current market conventions and often by contract, parties generally agree to utilize a mid-market level for margin purposes, and we recommend that the Commissions endorse this as a uniform market practice.

- ***Fair and Balanced Communication.*** The Commissions should clarify the standards for fair and balanced communication by reference to the existing Financial Industry Regulatory Authority ("FINRA") and National Futures Association ("NFA") standards for customer communication, subject to appropriate modifications to reflect the heightened standards for participation in the swap markets.

- ***Conflicts of Interest.*** The Commissions should clarify the scope of the informational barrier requirements under the conflicts of interest provisions of business conduct standard (j)(5) and, consistent with analogous statutory provisions and SRO rules for other markets, confirm that the provision will not be enforced under a strict liability standard, but under a standard that evaluates whether the barriers were reasonably designed to accomplish their intended purpose.

- ***Trading Records.*** The Commissions should confirm that, consistent with existing rules for the commodity futures and securities markets,[7] CEA Section 4s(g)(1) and SEA Section 15F(g)(1) require a Dealer or MSP to maintain recordings of telephone calls that the registrant creates in the course of its operations, but do not establish an affirmative new requirement that the registrant create recordings of all telephone conversations. The record retention period for such records should be significantly shorter than the retention period applicable to other business records.

II. Advising and Trading with Special Entities

Dealers and MSPs who advise and trade with "Special Entities" face heightened duties under Dodd-Frank.[8] The scope of the category of entities that qualify as Special Entities is unclear under these provisions. Additionally, both the scope of the duties owed by registrants to Special Entities, as well as the circumstances in which

[7] See NASD Rule 3010(b)(2); NFA Compliance Rule 2-9(a) and the associated Interpretive Notice 9021 "Enhanced Supervisory Requirements."

[8] With respect to funds that are MSPs, the Commissions should clarify that the business conduct standards described below apply to the funds themselves, not to the investment managers or advisors of such funds.

certain heightened duties arise, would benefit from clarification. We recommend that the Commissions use their rulemaking authority to clarify Dodd-Frank's Special Entity provisions in a manner that is consistent with analogous regulation of advisors under ERISA, which, consistent with common law, limits the imposition of fiduciary obligations to advisory relationships that are fiduciary in nature. In addition, as a general matter, the regulations should confirm that foreign entities will not be regarded as "Special Entities," in keeping with the general approach to extra-territorial jurisdiction under the CEA and SEA.

A. The Scope of "Special Entities"

"Special Entity" is defined under Dodd-Frank to include, among other persons, "any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002)."[9] We recommend that the Commissions address ambiguities regarding the scope of this prong of the "Special Entity" definition in the following manner:

- First, the Commissions should clarify not only that the definition of "employee benefit plan" in ERISA Section 3(3) is limited to plans and should not include collective investment vehicles in which plans invest but, more generally, that collective investment vehicles do not become Special Entities merely as a result of the investment by Special Entities in such vehicles. Examples of such vehicles include bank collective trust funds that consist of assets of unrelated pension plans[10] and investment funds that are more than 25% held by ERISA plans and thus subject to ERISA.[11, 12]

- Second, the rulemaking should specify that plans that are not subject to ERISA should not be encompassed within this prong of the "Special Entity" definition. Only those plans subject to the fiduciary responsibility provisions of ERISA – such as funded pension and welfare plans where assets are held by trusts and that are subject to extensive investment regulation by the Department of Labor – should be included in this prong. This interpretation would exclude such plans as (i) unfunded plans for highly compensated employees; (ii) foreign pension plans

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[9] CEA Section 4s(h)(2)(C)(iii); SEA Section 15F(h)(2)(C)(iii).

[10] See, e.g., Section 3(c)(11) of the Investment Company Act of 1940; Section 3(a)(2) of the Securities Act of 1933; and CFTC Regulation 4.5 (each providing applicable exclusions for bank collective trust funds).

[11] See ERISA "Plan asset regulation"; 29 CFR § 2510.3-101.

[12] The definition of "Special Entity" should encompass master trusts holding the assets of one or more funded plans of a single employer. Many employers combine one or more of their own pension plans into a master trust. Indeed, the assets of plans subject to ERISA's fiduciary responsibility requirements are generally held by a separate trust and such a trust would typically enter into swaps with a counterparty. Such plans should also receive the protections provided by Dodd-Frank.

> (including foreign-based governmental plans);[13] (iii) church plans that have elected not to subject themselves to ERISA; (iv) Section 403(b) plans that accept only employee contributions; and (v) Section 401(a), 403(b) and 457 plans sponsored by governmental entities.[14]

In addition, "Special Entity" is defined under Dodd-Frank to include, among other persons, "any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986." We recommend that the Commissions address the scope of this prong of the "Special Entity" definition by clarifying that it is limited to an endowment that itself enters into swaps, including swaps to manage or generate returns for its investment portfolio, and does not encompass a non-profit organization, the assets of which may include an endowment or funds designated by it as an endowment. Healthcare, higher education and other non-profit organizations, as borrowers on a taxable or tax-exempt basis, are frequent users of swaps, including as hedges in connection with their borrowings. A non-profit organization's swap may be contractually payable from legally available sources, which may include funds designated by it as endowment, or from another identified source. The proposed clarification would exclude such a non-profit organization, a result consistent with the definition of "Special Entity," which does not by its terms include non-profit organizations.

B. Advising Special Entities

1. Distinguishing Advisors and Counterparties

Dodd-Frank imposes significantly different responsibilities on advisors and counterparties to Special Entities. It obliges a Dealer who "acts as an advisor" to a Special Entity (MSPs do not face this heightened duty) to act in the "best interests" of the Special Entity.[15] Such a Dealer must also make "a reasonable determination that any swap recommended by the [swap/security-based swap] dealer is in the best interests of the Special Entity."[16] In contrast, Dealers and MSPs who are counterparties to Special Entities must satisfy a completely different set of requirements. Specifically, among other obligations, they must have a reasonable basis to believe that certain Special Entities have representatives independent of the Dealer or MSP who undertake to act in the best interests of the particular Special Entity. (In the case of employee benefit plans subject to ERISA, the Special Entity's independent representative must also be a fiduciary of that Special Entity.)

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[13] Excluding such plans appears to be consistent with congressional intent in the regulation of Dealers and MSPs. It would be odd to capture foreign governmental plans in CEA Section 4s(h)(2)(C)(iii) and SEA Section 15F(h)(2)(C)(iii) when they are excluded from CEA section 4s(h)(2)(C)(iv) and SEA section 15F(h)(2)(C)(iv) by virtue of the ERISA definition of "governmental plan."

[14] Presumably, this last category of plans would be covered under CEA Section 4s(h)(2)(C)(iv) and SEA Section 15F(h)(2)(C)(iv).

[15] CEA Section 4s(h)(4)(B); SEA Section 15F(h)(4)(B).

[16] CEA Section 4s(h)(4)(C); SEA Section 15F(h)(4)(C).

Notably, the precursor to Dodd-Frank initially passed by the Senate contained provisions, not included in the version passed earlier by the House, that would have imposed a "fiduciary duty" on a Dealer entering into a swap as a counterparty to a defined category of governmental entities as well as pension plans, endowments and retirement plans. That provision was struck during the House-Senate conference and replaced with Dodd-Frank's two-pronged framework, described above, that distinguishes the Dealer as counterparty from the Dealer as advisor.

This legislative history, Dodd-Frank's establishment of two distinct sets of responsibilities for advisors and counterparties, and the clear intention under business conduct standard (5)(A) that a fiduciary independent of a Dealer counterparty stand between the Dealer counterparty and a Special Entity together indicate unambiguously that Congress intended Dealers that are advisors and those that are merely counterparties to be distinguished by a bright line.

2. The Advisory Relationship under Dodd-Frank

By imposing an obligation on advisors to act in the best interests of their Special Entity counterparties, Congress imposed a "fiduciary-like" standard on advisors to the Special Entity. At the same time, Congress determined that a different, non-fiduciary standard should apply in the context of ordinary arm's-length transactions. A broad interpretation of the phrase "acts as an advisor" that would capture the ordinary course interactions between Dealers and counterparties, such as the provision of a term sheet suggesting a transaction structure for a swap, would contradict this clear congressional intent and render superfluous the provision specifying the responsibilities of counterparties who are not advisors. In addition, as a practical matter, any such broad construction would significantly impede Special Entity access to the market for swaps.

As a result, it is critical that the Commissions clarify the circumstances that give rise to advisor status and the attendant fiduciary obligations contemplated in business conduct standard (4)(B).

We note, preliminarily, that under common and statutory law, the obligation to act in the "best interests" of a third party arises in the context of a fiduciary relationship. Under FINRA, fiduciary relationships, in turn, do not arise from the mere provision of education, suggestions, recommendations or general or incidental advice of the kind that is customarily provided by a Dealer to a swap counterparty in order to facilitate the ordinary course structuring or negotiation of a transaction.[17] Instead,

[17] For example, FINRA imposes on broker-dealer member firms that make "recommendations" to customers an obligation to ensure that the recommendation is a "suitable" one. See NASD Rule 2310. Although this suitability obligation represents a heightened standard, it is not equivalent to the fiduciary obligation to determine whether the recommended security transaction is in the best interests of the customer.

fiduciary obligations arise in the context of advisory relationships in which the advisor is granted discretionary authority or in which the advisor is retained in order to provide personalized or tailored advice on which the advisee is expected to rely in making or authorizing an investment decision.

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

We believe that defining the term "advisor" in a manner consistent with the standards embodied in ERISA's current fiduciary rules would avoid the problems described above and be consistent with congressional intent.[18] Under those rules, a person is regarded as rendering advice only where its advice and/or discretionary authority, control or responsibility arise pursuant to an agreement, arrangement or understanding (written or otherwise) that the advice will serve as a primary basis for investment decisions with respect to the plan's assets.[19]

Such an interpretation would also be in keeping with the standards for an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act") and for a commodity trading advisor under the CEA. Under both these Acts, mere incidental recommendations or other statements describing potential transaction alternatives do not, standing alone, give rise to heightened fiduciary responsibilities.[20] To the contrary,

[18] Under ERISA Section 3(21), a person is a fiduciary with respect to a plan to the extent (s)he (i) exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so or (iii) has any discretionary authority or discretionary responsibility in the administration of such plan.

[19] See 29 CFR § 2510.3-21(c). On October 21, 2010, the Department of Labor issued proposed regulations that provide that a person does not become a fiduciary by reason of providing investment advice if "such person can demonstrate that the recipient of the advice knows or, under the circumstances, reasonably should know, that the person is providing the advice or making the recommendation in its capacity as a purchaser or seller of a security or other property, or as an agent of, or appraiser for, such a purchaser or seller, whose interests are adverse to the interests of the plan or its participants or beneficiaries, and that the person is not undertaking to provide impartial investment advice." If these regulations are adopted in final form, a swap counterparty should not be an advisor in circumstances where it is not a fiduciary under this standard.

[20] Similarly, the Commissions should clarify that heightened fiduciary responsibilities do not arise from the provision of analytical information that Dodd-Frank specifically contemplates being provided by a Dealer

through exclusions from registration for incidental or generalized advice, Congress has consistently recognized that it is this fiduciary relationship, rather than the mere provision of advice, that gives rise to the duty.[21] The courts and Commissions have supported this view by declining to find advisory relationships that are fiduciary in nature in the absence of a relationship of reliance and trust.[22] Indeed, in affirming the fiduciary nature of advisory relationships, regulatory authorities and courts have consistently looked for a relationship of trust and confidence between the advisor and client and reliance by the client.[23]

3. Evidence of an Advisory Relationship under Dodd-Frank

The existence of a fiduciary-like relationship between two parties is necessarily a function of their expectations. Accordingly, evidence of the parties' mutual understandings of the nature of their relationship should constitute the basis for determining the existence of such a relationship. Absent unusual circumstances involving evidence to the contrary, the strongest evidence of the parties' mutual understanding is the documentation of their relationship. We believe that in order to minimize the circumstances in which the parties to a swap proceed based on a misapprehension as to their appropriate expectations and responsibilities, the Commissions should strongly encourage Dealers and their Special Entity (indeed, all) counterparties to clearly articulate the nature of their relationship in the documentation

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or MSP, such as risk disclosure under business conduct standard (3)(B) or research or analysis addressed by the conflicts of interest provisions contained in CEA Section 4s(j)(5) and SEA Section 15F(j)(5).

[21] Section 202(a)(11) of the Advisers Act and CEA Section 1a(12) provide exceptions for lawyers, accountants, broker-dealers, publishers and others whose advice is either incidental to their profession or conduct or general in nature.

[22] See, e.g., Kwiatkowski v. Bear Stearns & Co., Inc., 306 F.3d 1293 (2d Cir. 2003) (explaining that, on a transaction-by-transaction basis, a broker owes duties of diligence and competence in executing the client's orders but that the giving of advice on particular occasions does not trigger an ongoing duty on the part of a broker to advise in the future and monitor all data potentially relevant to a customer's investment); SEC Staff Legal Bulletin No. 11 ("The Division believes … that Congress generally did not intend to apply the Advisers Act to any person who merely advises issuers concerning the structuring of their financings"); Division of Investment Management no-action letter David A. Kasich (available Mar. 19, 1992) ("the staff has stated that, in general, it does not interpret Section 202(a)(11) of the Advisers Act to apply to a person whose only advice consists of advising an issuer how to structure its financing"). See also NASD Rule 2310, supra note 17. Also note that Section 913 of the Dodd-Frank Act, which grants the SEC authority to impose a fiduciary duty on broker-dealers with respect to retail clients, only provides that authority in the context of broker-dealers providing "personalized" investment advice.

[23] See, e.g., Arleen W. Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948) (the "very function of furnishing investment counsel on a fee basis – learning the personal and intimate details of the financial affairs of clients and making recommendations as to purchases and sales of securities – cultivates a confidential and intimate relationship and imposes a duty to act in the best interests of [clients] and to make only such recommendations as will best serve such interests."); In re Jack Savage, CFTC Dkt. No. 78-1, Comm. Fut. L. Rep. (CCH) ¶20,139 (Mar. 1, 1976) (affirming decision and order at ¶20,082) ("[T]he customers of commodity trading advisors may depend solely on the advice of the commodity trading advisor in entering into transactions that are subject to the jurisdiction of the Commission. This is a fiduciary relationship ...")(emphasis added).

governing the transactions between them. This documentation should be understood to provide prima facie evidence of the capacity in which a Dealer or MSP is acting for the particular transaction or interaction at issue. Indeed, in light of the customary market practice of documenting the obligations and responsibilities of the parties to an advisory relationship in an engagement letter, advisory agreement or similar written agreement, the absence of such documentation should give rise to a strong inference that there is no advisory relationship, and an even stronger inference in cases where the Dealer has disclosed, in good faith, that it is acting as a counterparty and not as an agent, advisor or fiduciary. This approach would be consistent with, and build upon, the obligation under business conduct standard (5)(A)(ii) for Dealer counterparties to disclose to a Special Entity counterparty in writing the capacity in which it is acting.

In addition to consistency with the law of fiduciary relationships, the approach suggested above would also provide the bright line distinction required to implement congressional intent under Dodd-Frank without significantly disrupting the participation of Special Entities in the swap market or chilling ordinary course communication that benefits Special Entities in the course of transaction structuring and negotiation.

C. Counterparties to Special Entities

Dodd-Frank also imposes additional requirements upon any Dealer or MSP who "offers to" enter into a swap transaction with a Special Entity.[24] The condition precedent that the Dealer or MSP "offers to" enter into the transaction should be limited to situations in which the Dealer makes an offer that, if accepted, would become a binding contract. It should not cover circumstances where the Dealer provides illustrative examples or information about the swap market or particular swaps. This interpretation will ensure that information will flow freely in the marketplace in which Special Entities participate; a more expansive construction, in contrast, would impose costly obstacles to furnishing such illustrative examples to Special Entities. Similar guidance should apply to any rule or regulation related to fraud, manipulation or other abusive practices involving swaps.[25]

With respect to the special requirements with which a Dealer or MSP who "offers to or enters into" a transaction with a Special Entity must comply that are described in subparagraph (A)(i),[26] the lead-in language in that subparagraph clearly

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[24] CEA Section 4s(h)(5); SEA Section 15F(h)(5).

[25] See, e.g., CEA Section 4(h)(1)(A); SEA Section 15F(h)(1)(A).

[26] More particularly, business conduct standard (5)(A)(i) states:

(5) SPECIAL REQUIREMENTS FOR [DEALERS] AS COUNTERPARTIES TO SPECIAL ENTITIES.—

(A) Any [Dealer] or [MSP] that offers to enter or enters into a swap with a Special Entity shall—

limits the applicability of these requirements to "eligible contract participant[s] within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18)" of the CEA. These subclauses refer to "(I) a governmental entity (including the United States, a State, or a foreign government) or political subdivision of a governmental entity" and "(II) a multinational or supranational governmental entity." Special Entities that are ERISA plans are clearly excluded. Nevertheless, the language of subclause (VII) of subparagraph (A)(i) (*i.e.*, "in the case of employee benefit plans subject to [ERISA]…") seems intended to apply to Special Entities that are ERISA plans. Therefore, we believe that the Commissions should apply this subclause (VII) to Special Entities that are ERISA plans. The Commissions should not be concerned that the other subclauses do not expressly apply to Special Entities that are ERISA plans, since ERISA already imposes requirements similar to those enumerated in subclauses (I) – (VI) on any representative acting as a fiduciary to an ERISA plan.[27]

An additional requirement imposed upon Dealer and MSP counterparties is that the Dealer or MSP must disclose to the Special Entity in writing the "capacity in which the [swap/security-based swap] dealer is acting."[28] Dealers and MSPs should be permitted to meet this requirement through the use of standard disclosure to the effect that, unless otherwise specified for a particular transaction or transactions, the Dealer or MSP is acting as a principal and is not an agent, advisor or fiduciary for the Special Entity. Such disclosure should apply on a relationship basis and should be prima facie evidence that an advisory relationship does not exist, as discussed above. This provides both parties with the certainty essential for them to structure a suitable transaction.

(i) comply with any duty established by the Commission for a [Dealer] or [MSP], with respect to a counterparty that is an eligible contract participant within the meaning of <u>subclause (I) or (II) of clause (vii) of section 1a(18) of [the CEA]</u>, that requires the [Dealer] or [MSP] to have a reasonable basis to believe that the counterparty that is a Special Entity has an independent representative that—

(I) has sufficient knowledge to evaluate the transaction and risks;
(II) is not subject to a statutory disqualification;
(III) is independent of the [Dealer] or [MSP];
(IV) undertakes a duty to act in the best interests of the counterparty it represents;
(V) makes appropriate disclosures;
(VI) will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction; and
(VII) <u>in the case of employee benefit plans subject to the Employee Retirement Income Security act (*sic*) of 1974, is a fiduciary as defined in section 3 of that Act (29 U.S.C. 1002)</u>; … (emphasis added).

[27] <u>See</u>, <u>e.g.</u>, ERISA Sections 404(a)(1) (requiring ERISA fiduciaries to discharge their duties "solely in the interest of the participants and beneficiaries" of the plan and "with the care, skill, prudence, and diligence …that a prudent man acting in a like capacity and familiar with such matters would use") and 406(b) (prohibiting an ERISA fiduciary from, among other items, engaging in self-dealing); <u>Eddy v. Colonial Life Ins. Co. of Am.</u>, 919 F.2d 747, 750 (D.C. Cir. 1990) ("The duty to disclose material information is the core of a fiduciary's responsibility."); <u>California Ironworkers Field Pension Trust v. Loomis Sayles & Co.</u>, 259 F.3d 1036, 1043 (9th Cir. 2001) ("When applying the prudence rule, the primary question is whether the fiduciaries … 'employed the appropriate methods to investigate the merits of the investment and to structure the investment.'" (quoting <u>Donovan v. Mazzola</u>, 716 F.2d 1226, 1232 (9th Cir. 1983))).

[28] We assume that this provision is, notwithstanding the reference to a "swap dealer," intended to apply both to Dealers and MSPs.

In addition, Dealers and MSPs should be able to satisfy any duties to ascertain facts related to the Special Entity or its independent representative based on reasonable information, including representations, provided by the Special Entity or its independent representative unless the individual(s) relying on such representations or information know(s) such representations or information are not true. Such facts are principally within the control of the Special Entity or its independent representative, and the imposition of detailed diligence obligations on the Dealer or MSP would potentially place that party in the position of "second guessing," among other judgments, the Special Entity's selection of its independent representative. Examples of duties where Dealers and MSPs should be permitted to rely on reasonable information and representations provided by a Special Entity or its independent representative also include the duty to verify that the Special Entity (or other counterparty) satisfies the eligibility standards for an eligible contract participant[29] and the obligation under business conduct standard (4)(C) for an advisor to a Special Entity to obtain information necessary to make a reasonable determination that any recommended swap is in the best interests of the Special Entity.

Moreover, the Commissions should clarify that the word "independent" in the lead-in language of business conduct standard (5)(A)(i) means "independent of the [Dealer] or [MSP]," consistent with its use in sub-clause (III) of this business conduct standard. This allows counterparties to continue to rely on in-house managers otherwise meeting the criteria of an independent representative.

III. Disclosure Requirements

A. Disclosure of Material Risks and Contract Characteristics

Under Dodd-Frank, the Commissions must adopt rules requiring Dealers and MSPs to disclose material risks and characteristics of the swaps and security-based swaps they enter into with counterparties who are not Dealers or MSPs.[30] In doing so, the Commissions should consider and request comments regarding the use of standard disclosure templates that could be adopted on an industry-wide basis. The Commissions should additionally clarify that the disclosure requirements (i) can be satisfied by a registrant on a relationship (rather than a transaction-by-transaction) basis in cases where prior disclosures apply to and adequately address the relevant transaction and (ii) do not apply to transactions executed by a registrant on an exchange or a SEF or otherwise in circumstances where the registrant does not know the identity of its counterparty until immediately prior to (or after) execution.[31]

[29] CEA Section 4s(h)(3)(A); SEA Section 15F(h)(3)(A).

[30] CEA Section 4s(h)(3)(B)(i); SEA Section 15F(h)(3)(B)(i).

[31] In addition, consideration should be given to the appropriate allocation of responsibilities in the context of give-up transactions involving swaps.

Each of the Commissions has, for many years, successfully permitted the use of standardized disclosure statements for derivatives in the context of establishing accounts to trade options, futures and stock futures with investors, including retail investors.[32] These models provide good precedents for a format that would facilitate consistent practices and disclosure quality across market participants, while providing an efficient and cost-effective mechanism for registrants to satisfy their statutory obligations. The market risks associated with swaps are generally not qualitatively different from those in the futures and options markets. Given the heightened standards for participation in the swap market, the development of a standardized disclosure template for swaps should, if anything, be more straightforward than was the case for the retail markets in futures and options. Additionally, the process of developing standardized disclosure materials would also provide a means for identifying circumstances in which more tailored disclosure might be appropriate and to formulate a framework applicable to such disclosure that would provide clarity and certainty to registrants, and minimize after-the-fact subjective judgments regarding the adequacy of compliance with applicable disclosure standards.

It remains unclear to us precisely what is intended by the reference to swap "characteristics" under business conduct standard (3)(B)(i). There is no better description of the characteristics of a transaction than the contract provisions expressly defining its economic terms. We recommend that the Commissions clarify that, to the extent that a counterparty is in possession of the master documentation and confirmation specifying the economic and other material terms of a specific transaction, registrant counterparties will have satisfied this requirement.

There has been some suggestion that registrants should be required to provide scenario or sensitivity analysis to counterparties in connection with swap transactions. Disclosure of the simplest types of scenario analysis (such as the computation of the terminal value of an interest rate swap in the context of an assumed rate of interest) or sensitivity analysis (such as the value of an option relative to its

[32] See, e.g., Rule 9b-1 under the SEA (requiring that a broker-dealer, before or at the time it approves a customer's account or accepts the customer's order to trade options, disclose to the customer certain general information, including a discussion of the mechanics of exercising the options and a general identification of the type of instrument or instruments underlying the options class or classes covered by the document); "Characteristics & Risks of Standardized Options," Options Clearing Corporation (options disclosure document for exchange-traded options); CFTC Rule 1.55 (specifying standardized, general language that must be furnished to a customer opening a commodity futures account, although a statement approved by one or more foreign regulatory agencies or self-regulatory agencies may also be used); CFTC Rule 32.5 (specifying both general terms that must be included and standardized language that a person soliciting or accepting an order of commodity options must provide to their counterparty); CFTC Rule 33.7(b) (stipulating standardized language to be furnished to a client opening or causing the opening of a commodity option account, in the event the FCM does not seek the CFTC's approval of another statement); and CFTC Rule 190.10(c) (stipulating standardized, general language that a commodity broker must furnish to a customer in order to accept non-cash property to margin, guarantee, or secure a commodity contract).

underlier given an assumed level of volatility) is unlikely to be necessary or desired by the vast majority of counterparties eligible to transact in OTC swaps, who must at the least be eligible contract participants and, in the case of Special Entities, are required to have a knowledgeable independent representative. On the other hand, more elaborate scenario and sensitivity analyses go beyond risk disclosure and incorporate subjective judgments about the probable or possible future market states and their relevance to a particular transaction. Although there may be cases where, as a commercial matter, a Dealer or MSP decides to provide such an analysis when marketing a swap, the Commissions should not require the Dealer or MSP to do so. Rather, given the level of sophistication of OTC swap counterparties – and in order to avoid effectively endorsing reliance on a Dealer or MSP that does not have a fiduciary responsibility to its counterparty – the Commissions should encourage all counterparties to model (or have their advisors model) the range of probable outcomes presented by a transaction using their own judgments and probability criteria.

B. Disclosure of Material Incentives or Conflicts of Interest

Under Dodd-Frank, the Commissions must also establish rules requiring the disclosure of material incentives or conflicts of interest a Dealer or MSP may have in connection with a given transaction.[33] SIFMA and ISDA strongly urge the Commissions, consistent with the risk disclosure requirements discussed above, to consider and request comments regarding the use of standardized disclosure templates to satisfy these requirements. The Commissions should additionally clarify that these disclosure requirements (i) can be satisfied by a registrant on a relationship (rather than a transaction-by-transaction) basis[34] in cases where prior disclosures apply to and adequately address the relevant transaction and (ii) do not apply to transactions executed by a registrant on an exchange or a SEF or otherwise in circumstances where the registrant does not know the identity of its counterparty until immediately prior to (or after) execution.[35]

Additionally, consistent with Dodd-Frank's mandate to protect the identity (and therefore the sensitive commercial information of a market participant) in connection with otherwise public transaction reporting requirements,[36] the Commissions should clarify that Dealers and MSPs will not be required to disclose specific, non-public transactions, positions or risk profiles to swap counterparties in connection with any mandatory disclosure of material incentives or conflicts of interest.

[33] CEA Section 4s(h)(3)(B)(ii); SEA Section 15F(h)(3)(B)(ii).

[34] For example, certain disclosures can be included in the ISDA Master Agreement or in other documents provided to the counterparty at the inception of the trading relationship.

[35] See note 31 regarding disclosure responsibilities in the context of give-ups.

[36] See, e.g., CEA Section 2(a)(13)(B), (C)(iii), (E); SEA Section 13(m)(B), (C)(iii), (E).

In lieu of any such potentially prejudicial disclosure, Dealers and MPSs (to the extent they are acting as arm's-length counterparties and not as fiduciaries) should be permitted to satisfy their disclosure obligations under these provisions through more generic disclosures. For instance, a Dealer or MSP might disclose that it and/or its affiliates engage or may engage in hedging or trading in the same or related markets and that such activity could adversely affect prices for the relevant underlier or the amounts payable under the swap. Similarly, in the context of a security-based swap, it may be appropriate for the Dealer or MSP to disclose that it or its affiliate is or may be an underwriter and may engage in stabilizing transactions in connection with the specific security underlying the security-based swap or that it may have banking or commercial relationships with the issuer of the underlying security or reference entity.

We believe that such an approach would effectively satisfy Dodd-Frank's disclosure objective while avoiding disclosures that would potentially be unduly prejudicial to registrants.

C. Exchange/SEF-Traded Swaps

As briefly noted above, the Commissions should additionally clarify that the disclosure requirements (i) can be satisfied by a registrant on a relationship (rather than a transaction-by-transaction) basis in cases where prior disclosures apply to and adequately address the relevant transaction and (ii) do not apply to transactions executed by a registrant on an exchange or a SEF or otherwise in circumstances where the registrant does not know the identity of its counterparty until immediately prior to (or after) execution.[37] This interpretation would be consistent with congressional intent to encourage trading on exchanges and SEFs, since an alternative approach requiring disclosure for each swap executed on an exchange or SEF would render such swaps wholly impractical.

This interpretation would also be consistent with the broader provision providing an exception from the application of business conduct requirements generally (not just disclosure requirements) to transactions that are "initiated by a Special Entity on an exchange or swap execution facility" and in which the Dealer or MSP does not know the identity of its counterparty.[38]

In addition, we note that it is not clear what the reference to "initiated" means in the context of this provision. We request that the Commissions clarify that this

[37] See note 31 regarding disclosure responsibilities in the context of give-ups.

[38] An ambiguity exists regarding the scope of the CEA version of this business conduct provision. CEA Section 4s(h)(7) states that the relevant "section" should not apply with respect to transactions that are "initiated by a Special Entity on an exchange or swap execution facility" and in which the Dealer or MSP does not know the identity of its counterparty. It is unlikely that the reference to "section" in this provision was intended to refer to all of the registration and regulatory provisions applicable to Dealers and MSPs contained in CEA Section 4s, particularly in light of the fact that the analogous provision in SEA Section 15F refers more accurately to the specific subsection on business conduct standards.

latter exception for Special Entities, as well as the clarification regarding disclosure requirements requested above, applies in the case of any transaction executed by a market participant on an exchange or SEF regardless of the manner in which the non-registrant interacts with others' orders on the exchange or SEF.

D. Disclosure of Marks for Uncleared Swaps and Security-Based Swaps

The Commissions are also required by Dodd-Frank to establish rules for the disclosure of daily "marks" from the Dealer or MSP to the counterparty for uncleared transactions.[39] The reference to the term "marks" in this context is unclear. We believe that this provision is intended to provide substantially equivalent information to counterparties to uncleared transactions to that provided through the publication of settlement prices by clearinghouses. Settlement prices in the context of cleared transactions disclose the basis on which the clearinghouse determines the level of variation margin (or "mark-to-market collateral") it is paying to or demanding of the holders of cleared positions.

We believe that the requirement to disclose a "daily mark" for an uncleared swap transaction is intended for a similar purpose – to disclose, in the context of transactions for which the parties have entered into margining arrangements, the basis for computing any margin call – and is not intended to impose an obligation on registrants to perform valuation services for their counterparties. Such marks are not intended to represent actionable levels at which transactions can be executed. This suggested reading would be consistent with the related requirement applicable to transactions in cleared swaps that, upon the request of the counterparty, the Dealer or MSP shall disclose the daily mark from the appropriate derivatives clearing organization or clearing agency.[40]

A broader reading of this requirement would essentially require Dealers and MSPs to perform pricing or valuation services for their counterparties, which would potentially require access to additional information to which the Dealer or MSP may not have access (and which its counterparty may well not want to disclose to the Dealer or MSP) – such as whether other transactions in the same underlier create position concentration that would affect the liquidity and value of the counterparties' swap position. Any such approach could significantly increase the costs of entering into swap transactions.[41] Instead, we recommend that the Commissions admonish parties not to rely on their counterparties for the valuation of outstanding transactions but to perform their own valuations or utilize independent valuation resources.

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[39] CEA Section 4s(h)(3)(B)(iii)(II); SEA Section 15F(h)(3)(B)(iii)(II).

[40] CEA Section 4s(h)(3)(B)(iii)(I); SEA Section 15F(h)(3)(B)(iii)(I).

[41] The incremental transparency benefits of such a broader reading are also likely to be minimal in light of Dodd-Frank's public trade reporting requirements.

By market convention and often by contract, parties generally agree to utilize a mid-market level for margin purposes. Counterparties understand that this level does not represent a valuation at which a transaction may be entered into or terminated and accordingly may differ from actual market prices. We recommend that the Commissions endorse this use of mid-market levels for margin purposes as a uniform market practice.

SIFMA and ISDA further request that the Commissions clarify that Dealers and MSPs may satisfy their disclosure obligations under this provision, consistent with other disclosure regimes, by making the relevant information available to counterparties through password protected access to a webpage containing the relevant information.

IV. Fair and Balanced Communications

Dodd-Frank also requires the Commissions to establish a duty for Dealers and MSPs to communicate with their counterparties in a fair and balanced manner based on the principles of fair dealing and good faith.[42] We recommend that the Commissions adopt standards for this purpose that are similar in content and scope to existing customer communication standards for other markets, such as those applicable under FINRA and NFA rules,[43] subject to such adjustments as may be appropriate in light of the heightened standards for participation in the swaps market.

V. Conflicts of Interest Procedures

Dealers and MSPs are also required under Dodd-Frank to implement systems and procedures to address conflicts-of-interest.[44] One measure such firms are required to take is to establish appropriate informational barriers. However, this provision's language is extremely unclear and potentially internally inconsistent.[45] It is critical that the Commissions provide clarity as to the contours of the informational barriers and other measures that are required by this provision and the persons covered by them. For instance, the Commissions should permit personnel involved in pricing or trading to distribute research as part of their standard marketing function. In addition to clarifying this provision, we request that the Commissions clarify, through rulemaking, that the obligations established under this provision are not to be enforced under a strict liability standard, but rather under a standard that evaluates whether the barriers were reasonably designed to accomplish their intended purpose.

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[42] CEA Section 4s(h)(3)(C); SEA Section 15F(h)(3)(C).

[43] See, e.g., NFA Compliance Rule 2-29 and FINRA Rule 2010.

[44] CEA Section 4s(j)(5); SEA Section 15F(j)(5).

[45] The provision could be read, for example, to require "any person . . . providing clearing activities" to be "separated by appropriate informational partitions within the firm from the review, pressure, or oversight of persons whose involvement in . . . clearing activities might potentially bias their judgment."

VI. Responsibilities Regarding Trading Records

Dodd-Frank requires Dealers and MSPs to "maintain" daily trading records of their swaps and "all related records," including "recordings of telephone calls."[46] SIFMA and ISDA request that the Commissions clarify that these provisions require a Dealer or MSP to maintain recordings of telephone calls that the registrant creates in the course of its operations but does not establish an affirmative new requirement that the registrant create recordings of all telephone conversations. Any such affirmative obligation would impose an enormous administrative and technological burden on Dealers and MSPs, effectively requiring the recording and cataloguing of every call related to every transaction or potential transaction. Such systems would be both impractical and unduly expensive. We note in this regard that SRO rules for other markets generally do not require tape recording of conversations except in extraordinary cases involving firms that have a large percentage of employees previously associated with disciplined firms.[47] In addition, in certain jurisdictions, recording a telephone conversation without the consent of parties is a crime.

Additionally, because telephone recordings are generally created for the specific purpose of evidencing the terms of a transaction that will be separately documented, the record retention period for any such recordings should be significantly shorter than the retention period applicable to other business records.

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SIFMA and ISDA appreciate the opportunity to comment on the business conduct provisions of Dodd-Frank. We would be pleased to discuss any of the comments or recommendations in this letter with the staff of the Commissions. Please do not hesitate to contact the undersigned or our staff with any questions regarding the foregoing.

Respectfully submitted,

Kenneth E. Bentsen, Jr.	Robert G. Pickel
Executive Vice President	Executive Vice Chairman
Public Policy and Advocacy	ISDA
SIFMA	

[46] CEA Section 4s(g)(1); SEA Section 15F(g)(1).

[47] See NASD Rule 3010(b)(2); NFA Compliance Rule 2-9(a) and the associated Interpretive Notice 9021 "Enhanced Supervisory Requirements."