

# COMMITTEE ON CAPITAL MARKETS REGULATION

May 10, 2011

The Honorable Tim Johnson  
Chairman  
United States Senate Committee on Banking,  
Housing, and Urban Affairs  
136 Hart Senate Office Building  
Washington, DC 20510

The Honorable Debbie Stabenow  
Chairwoman  
United States Senate Committee on  
Agriculture, Nutrition and Forestry  
133 Hart Senate Office Building  
Washington, DC 20510

The Honorable Richard Shelby  
Ranking Member  
United States Senate Committee on Banking,  
Housing, and Urban Affairs  
304 Russell Senate Office Building  
Washington, DC 20510

The Honorable Pat Roberts  
Ranking Member  
United States Senate Committee on  
Agriculture, Nutrition and Forestry  
109 Hart Senate Office Building  
Washington, DC 20510

The Honorable Spencer Bachus  
Chairman  
United States House of Representatives  
Committee on Financial Services  
2246 Rayburn House Office Building  
Washington, DC 20515

The Honorable Frank D. Lucas  
Chairman  
United States House of Representatives  
Committee on Agriculture  
2311 Rayburn House Office Building  
Washington, DC 20515

The Honorable Barney Frank  
Ranking Member  
United States House of Representatives  
Committee on Financial Services  
2252 Rayburn House Office Building  
Washington, DC 20515

The Honorable Collin Peterson  
Ranking Member  
United States House of Representatives  
Committee on Agriculture  
2211 Rayburn House Office Building  
Washington, DC 20515

Re: Business Conduct Standards for Swap Dealers and Major Swap Participants

Dear Chairman Johnson, Ranking Member Shelby, Chairman Bachus, Ranking Member Frank, Chairwoman Stabenow, Ranking Member Roberts, Chairman Lucas, and Ranking Member Peterson:

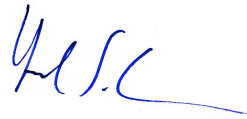
Please find enclosed a comment letter the Committee on Capital Markets Regulation filed recently with the CFTC regarding its proposed rules concerning business conduct standards for swap dealers and major swap participants.<sup>1</sup>

<sup>1</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80,638 (proposed Dec. 22, 2010) (Proposed Rules).

We would like to draw your attention to our discussion of a swap dealer's duty to evaluate the independent representative of a "Special Entity," like a pension fund. The Dodd-Frank Act requires a dealer entering into a swap with a Special Entity to "have a reasonable basis to believe" that the Special Entity has an independent representative.<sup>2</sup> The CFTC's proposed rules go beyond that statutory text and would require the dealer to evaluate the qualifications of the independent representative, including the "facts and circumstances of a particular Special Entity-representative relationship."<sup>3</sup>

This requirement goes too far. As the attached comment letter explains, extensive investigations by dealers would burden Special Entities with additional costs and could weaken an asset manager's negotiating position with dealers. Imposition of these costs could also result in Special Entities avoiding using swaps as risk management tools altogether, thus unnecessarily increasing their own risks. This set of proposed rules deserves the attention of your Committees because it exceeds the statutory requirements in a way that will unnecessarily burden the marketplace.

Sincerely,



Hal S. Scott  
President & Director  
Committee on Capital Markets Regulation

<sup>2</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 731.

<sup>3</sup> Proposed Rules § 23.450(d), 76 Fed. Reg. at 80,660.

# COMMITTEE ON CAPITAL MARKETS REGULATION

May 3, 2011

David A. Stawick  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Centre, 1155 21st Street, NW  
Washington, DC 20581

Re: Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80638 (RIN 3038-AD25)

Dear Mr. Stawick:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the Proposed Rules<sup>1</sup> of the Commodity Futures Trading Commission (CFTC) regarding business conduct standards for a swap under § 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>2</sup>

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains fifty-seven recommendations for making the U.S. financial regulatory structure more integrated, more effective, and more protective of investors in the wake of the financial crisis of 2008.<sup>3</sup> Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

This letter addresses the situation in which an independent representative, such as an asset manager, is engaged by a Special Entity, such as a pension plan, to negotiate and enter into swaps on behalf of the Special Entity. Our comments are focused on the provisions in the Proposed Rules regarding the evaluation of a Special Entity's independent representative, and the possibility of establishing a fiduciary standard.

<sup>1</sup> Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80,638 (proposed Dec. 22, 2010) (hereinafter Proposed Rules).

<sup>2</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 731 (hereinafter Dodd-Frank Act).

<sup>3</sup> COMM. ON CAPITAL MKTS. REG., *THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM* (May 2009), <http://www.capmksreg.org/research.html>.

## Evaluation of Independent Representative

Section 731 of the Dodd-Frank Act requires that “Any swap dealer or major swap participant that offers to enter or enters into a swap with a Special Entity<sup>[4]</sup> shall comply with any duty established by the [CFTC]...that requires the swap dealer or major swap participant to have a reasonable basis to believe that the counterparty that is a Special Entity has an independent representative” that meets several criteria.<sup>5</sup>

The Proposed Rules restate this requirement and the statutory criteria and then, for swap dealers but not for major swap participants, expand on them by adding criteria on how to establish the required “reasonable basis” for evaluating the counterparty’s independent representative. Specifically, the dealer may rely upon written representations of the Special Entity only to the extent that:

- (1) The swap dealer has a reasonable basis to believe that the representations are reliable taking into consideration the facts and circumstances of a particular Special Entity-representative relationship, assessed in the context of a particular transaction;
- (2) The representations include information sufficiently detailed for the swap dealer reasonably to conclude that the representative satisfies the criteria.<sup>6</sup>

The Proposed Rules then list seven relevant considerations for how the written representations may satisfy the criteria.<sup>7</sup>

Once the Special Entity has evaluated and selected its own independent representative, its swap dealer counterparty should be able to rely upon the Special Entity’s written representation that the representative meets the statutory and regulatory criteria. The dealer should be required to probe beyond that representation only if it has reason to believe that the Special Entity’s representations with respect to its independent representative are inaccurate. This would reduce the potential burden on Special Entities that would result from extensive dealer investigations. Imposition of these costs could result in Special Entities avoiding using swaps as risk management tools altogether, thus unnecessarily increasing their own risks. Further, it avoids giving dealers additional leverage that could weaken the asset manager’s negotiating position in obtaining the best deal for its client.

<sup>4</sup> “Special Entity” means: (1) a federal agency; (2) a state, state agency, city, county, municipality, or other political subdivision; (3) an employee benefit plan; (4) a government retirement plan; or (5) an endowment. *See* Proposed Rules § 23.401, 76 Fed. Reg. at 80,657.

<sup>5</sup> Dodd-Frank Act § 731 (paragraph breaks omitted). Specifically, it must have an independent representative that: “(1) has sufficient knowledge to evaluate the transaction and risks; (2) is not subject to a statutory disqualification; (3) is independent of the swap dealer or major swap participant; (4) undertakes a duty to act in the best interests of the counterparty it represents; (5) makes appropriate disclosures; (6) will provide written representations to the Special Entity regarding fair pricing and the appropriateness of the transaction; and (7) in the case of employee benefit plans subject to the Employee Retirement Income Security act of 1974, is a fiduciary as defined in section 3 of that Act (29 U.S.C. 1002).” *Id.* (paragraph breaks omitted and renumbered).

<sup>6</sup> Proposed Rules § 23.450(d), 76 Fed. Reg. at 80,660.

<sup>7</sup> *See id.* § 23.450(d)(2)(i)–(vii), 76 Fed. Reg. at 80,660–61.

The Dodd-Frank Act requires a dealer to have only a “reasonable basis to believe” that the representative meets the criteria.<sup>8</sup> In the absence of any facts suggesting otherwise, the Special Entity’s representation should presumptively satisfy that statutory requirement. There is no need for the rules to go any further.

### **Fiduciary Duty**

The proposed rules ask, “Should swap dealers be subject to an explicit fiduciary duty when making a recommendation to a counterparty?”<sup>9</sup> The short answer is no.

The Dodd-Frank Act contemplates rules requiring appropriate disclosures to counterparties, as well as rules designed to prevent “fraud, manipulation, and other abusive practices,”<sup>10</sup> but does not mandate the establishment of a fiduciary duty for swap dealers. The Proposed Rules require a swap dealer or MSP to consider the counterparty’s institutional suitability: “A swap dealer or major swap participant shall have a reasonable basis to believe that any swap or trading strategy involving swaps recommended to a counterparty is suitable for the counterparty based on information obtained through reasonable due diligence.”<sup>11</sup> The rules also specify how the swap dealer or MSP will fulfill that obligation. It must (1) reasonably believe the counterparty is capable of evaluating the risks of the swap or trading strategy, (2) receive affirmative confirmation that the counterparty is exercising independent judgment, and (3) reasonably believe the counterparty can absorb potential losses.<sup>12</sup> These conditions, in conjunction with the other rules and statutory provisions prohibiting abusive practices, are sufficient to protect the counterparty, particularly when the counterparty is an independent representative.

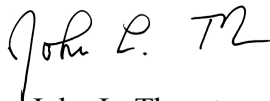
In addition, if a swap dealer had a fiduciary duty to a Special Entity that is subject to the Employee Retirement Income Security Act of 1974 (ERISA),<sup>13</sup> then the swap transaction itself would become a prohibited transaction under applicable ERISA rules. A prohibited transaction under ERISA could subject the Special Entity, its advisor, and the swap dealer to significant liability. Adopting a fiduciary standard would harm such Special Entities, as it would result in these entities no longer being able to utilize swaps for any purpose.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

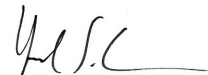
Respectfully submitted,



R. Glenn Hubbard  
Co-CHAIR



John L. Thornton  
Co-CHAIR



Hal S. Scott  
DIRECTOR

<sup>8</sup> See Dodd-Frank Act § 731.

<sup>9</sup> Proposed Rules, 76 Fed. Reg. at 80,648.

<sup>10</sup> Dodd-Frank Act § 731.

<sup>11</sup> Proposed Rules § 23.434(a), 76 Fed. Reg. at 80,659.

<sup>12</sup> *Id.* § 23.434(b)(1).

<sup>13</sup> Pub. L. No. 93-406, 88 Stat. 829.