

# COMMITTEE ON CAPITAL MARKETS REGULATION

August 26, 2011

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street NE  
Washington, DC 20549

Re: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 75 Fed. Reg. 42,396 (RIN 3235-AL10, SEC Release No. 34-64766, File No. S7-25-11)

Dear Ms. Murphy:

The Committee on Capital Markets Regulation (Committee) appreciates the opportunity to comment on the Proposed Rules<sup>1</sup> of the Securities and Exchange Commission (SEC) regarding business conduct standards under § 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).<sup>2</sup>

Since 2005, the Committee, composed of 32 members, 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 security-based 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.

Section 764 of the Dodd-Frank Act requires that “[a]ny security-based swap dealer or major security-based swap participant that offers to or enters into a security-

<sup>1</sup> Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 75 Fed. Reg. 42,396 (proposed July 18, 2011) (hereinafter SEC Proposed Rules).

<sup>2</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 764 (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.capmktreg.org/research.html>.

based swap with a special entity<sup>[4]</sup> shall comply with any duty established by the [SEC] for a security-based swap dealer or major security-based swap participant...that requires the security-based swap dealer or major security-based 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> Section 731, which falls under the jurisdiction of the CFTC, is nearly identical.

The CFTC recently issued its own proposed rules implementing this section. Its proposal expanded on the statutory requirements 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>

In addition, the CFTC outlines seven considerations for swap dealers to use in determining whether the representative satisfies the criteria.<sup>7</sup>

We submitted comments to the CFTC about its companion rule.<sup>8</sup> We criticized the CFTC’s approach and made the following recommendation:

Once the Special Entity has evaluated and selected its own independent representative, its swap dealer counterparty should be able to rely upon the

<sup>4</sup> Special entity means: “(1) A Federal agency; (2) A State, State agency, city, county, municipality, or other political subdivision of a State; (3) Any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); (4) Any governmental plan, as defined in section 3(32) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(32)); or (5) Any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986.” SEC Proposed Rules, § 240.15Fh-2(e), 76 Fed. Reg. at 42,454 (paragraph breaks omitted).

<sup>5</sup> Dodd-Frank Act § 764 (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 security-based swap dealer or major security-based 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> Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties § 23.450(d), 75 Fed. Reg. 80,600 at 80,638 (proposed Dec. 22, 2010) (hereinafter CFTC Proposed Rules).

<sup>7</sup> CFTC Proposed Rules § 23.450(d)(2)(i)–(vii), 76 Fed. Reg. at 80,660–61.

<sup>8</sup> Letter from the Comm. on Capital Mkts. Reg. to David A. Stawick, Secretary of the Commodity Futures Trading Commission (May 3, 2011), [http://www.capmksreg.org/pdfs/2011.05.03\\_Busines\\_Conduct\\_Comment\\_Letter.pdf](http://www.capmksreg.org/pdfs/2011.05.03_Busines_Conduct_Comment_Letter.pdf).

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.<sup>9</sup>

We are pleased that the SEC's proposal generally is consistent with our recommendations on this point. The SEC's release explains:

We preliminarily believe that, except as specifically noted below, an SBS Entity could rely on written representations regarding the various qualifications of the independent representative to form a reasonable basis to believe that the independent representative is "qualified". Upon receiving such representations, the SBS Entity would be entitled to rely on them without further inquiry, absent special circumstances described below.<sup>10</sup>

The SEC's proposal then explains two alternatives. Under one alternative, an SBS Entity would be able to rely on written representations unless it has actual knowledge that the representation is inaccurate; under the other alternative, it could rely unless it has information that would cause a reasonable person to question the accuracy of the representation.<sup>11</sup>

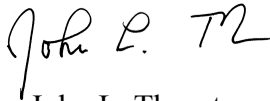
Either of these alternatives is preferable to the CFTC approach. As we explained in our comment letter to the CFTC, "The Dodd-Frank Act requires a dealer to have only a 'reasonable basis to believe' that the representative meets the criteria.<sup>[12]</sup> In the absence of any facts suggesting otherwise, the Special Entity's representation should presumptively satisfy that statutory requirement. There is no need for the rules to go any further."<sup>13</sup> We encourage the SEC to maintain the approach set forth in its proposal, and also reiterate our position that the CFTC should adopt this approach.

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.

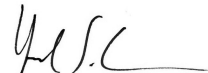
Respectfully submitted,



R. Glenn Hubbard  
Co-CHAIR



John L. Thornton  
Co-CHAIR



Hal S. Scott  
DIRECTOR

<sup>9</sup> *Id.* at 2.

<sup>10</sup> SEC Proposed Rules, 76 Fed. Reg. at 42,428 (footnote omitted).

<sup>11</sup> *Id.* at 42,428.

<sup>12</sup> Dodd Frank Act § 731; *accord id.* § 764.

<sup>13</sup> Letter from the Comm. on Capital Mkts. Reg. to David A. Stawick, Secretary of the Commodity Futures Trading Commission 3, *supra* note 8.