MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

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Via Electronic Submission: http://comments.cftc.gov

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

Re: RIN No. 3038-AD25: Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties

Dear Mr. Stawick:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "Commission") with respect to its proposed rules on "Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties",[2] under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] MFA supports the Proposed Rule and the Commission's general approach to establishing business conduct standards with which swap dealers ("SDs") and major swap participants ("MSPs") must comply because we believe it is a useful measure that will help to reduce risk, increase transparency and promote market integrity within the financial system. As a result, we look forward to working closely with the Commission to ensure that the final promulgated rules serve the public interest and help to establish a regulatory regime that imposes appropriate duties on SDs and MSPs.

I. Summary

MFA generally agrees with the Commission's approach to the business conduct standards. However, as a general comment, MFA respectfully suggests that the Commission, with respect to the Proposed Rule and all other rulemakings, consider separate regulatory regimes for SDs and MSPs. There are fundamental differences in the businesses, structures and

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[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] 75 Fed. Reg. 80,638 (Dec. 22, 2010) (the "Proposed Rule").

[3] Pub. L. No. 111-203.

other characteristics of SDs and MSPs,[4] and fundamentally different reasons why the Dodd-Frank Act requires additional oversight of each. We believe that the Commission should focus MSP regulation on reducing default risk and focus SD regulation on market making and pricing and sales practices, in addition to default risk. Accordingly, MFA respectfully suggests that the Commission use this opportunity to implement regulations that are tailored to the specific, different market realities in which SDs and MSPs operate. In certain circumstances, identical rules will be appropriate for both types of entities, but that will not always be the case (*e.g.*, counterparty duties and capital and margin requirements) and, in some circumstances, it might create unintended harm if the Commission applied one regulatory regime to such different types of market participants.

In addition, specifically with respect to the Proposed Rule, we are concerned that certain aspects of the Proposed Rule are unnecessary in the current market environment or impose standards that are too onerous. In particular, we feel that the increased costs that will result from aspects of the Proposed Rule outweigh the benefits that market participants may receive. In addition, we are concerned that the "Diligent Supervision", "Suitability Recommendation" and "Qualified Representative" rules (each as defined in Section III below) may impose new fiduciary obligations or supervisory duties on market participants to which they otherwise would not be subject. As a result, MFA urges the Commission to reassess the necessity of certain aspects of the Proposed Rule, and we specifically recommend that the Commission:

(i) clarify that an MSP is not subject to any of the counterparty duties to which an SD is subject;

(ii) clarify that the Proposed Rule does not impose any new fiduciary or supervisory obligations or duties on market participants (*i.e.*, duties beyond those to which participants in the futures and derivatives markets would otherwise be subject by agreement or by operation of common law);

(iii) reassess the Proposed Rule with respect to the "know your counterparty", "scenario analyses" and "daily mark" requirements; and

(iv) confirm that the definition of "special entity" in the Proposed Rule does not include investment vehicles in which endowments, employee benefit plans or government entities invest.

II. Distinction between SDs and MSPs

Summary: The Commission should make it explicitly clear that an MSP acting in **the market on an arm's**-length basis is not subject to *any* of the counterparty duties to which an SD is subject.

[4] The Commission has not yet promulgated final rules defining MSP and SD, but for the remainder of this letter, when reference is made to either MSP or SD, it shall mean an entity likely to be included in such category based on the Securities and Exchange Commission's and the Commission's current joint proposed definitions.

The Proposed Rule implies equivalence between an MSP and an SD, but this should not be the case. Although the Dodd-Frank Act imposes similar obligations on SDs and MSPs,[5] it does not state that the Commission must subject SDs and MSPs to identical regulation. SDs and MSPs are entirely different entities, as the definitions of such terms in the Dodd-Frank Act[6] make clear. Generally, the SD definition applies to market makers or others that hold themselves out as dealers to customers, while the MSP definition applies to non-dealers with substantial positions in swaps. In the marketplace, entities acting as SDs are performing sell-side functions where they have duties to their customers, whereas MSPs are essentially without exception on the buy-side and do not interact with customers or other buy-side counterparties.

Since there are fundamental differences in the businesses, structures and other characteristics of SDs and MSPs, the Commission should not use the same regulatory regime to oversee such different market participants. Rather, the Commission should focus MSP regulation on reducing default risk and focus SD regulation on market making and pricing and sales practices, in addition to default risk. Accordingly, MFA respectfully suggests that the Commission use this opportunity to adopt implementing regulations that are tailored to the specific, different market realities in which SDs and MSPs operate.

Moreover, simply because a market participant is an MSP and has a large portfolio in a given asset class, should not mean it interacts with customers to which it owes any duty. For example, an investment fund is purely an investor and a financial end user, and as such, acts in the market as a buy-side participant and counterparty to dealers. Thus, if an investment fund were to become an MSP due to the size of its position in a particular asset class, that should not change its status or obligations because the investment fund would continue to be a buy-side market participant and would not be trading with customers to which it owes a duty. Accordingly, MSPs should not bear the dealer-linked burdens of an SD that trades with customers – *i.e.*, the entire regulatory framework from know-your-customer rules to best execution obligations. Such a result would create barriers to competition and to the evolution of an open trading marketplace.

We believe that it would be inappropriate for the Commission to impose the same duties on MSPs as those that the Commission or the National Futures Association ("NFA") imposes on futures commission merchants ("FCMs") and other SDs. Because an MSP's counterparties are typically dealers, an MSP would be expected to conduct its business on an arm's-length basis with its counterparties and not act in an advisory role. In such circumstances, the Commission should not hold the MSP to a fiduciary standard similar to that of an FCM or an SD that is not acting at arm's-length. It is a tenet of basic corporate law that fiduciary duties normally do not arise in situations where the parties conduct business at arm's-length.[7] Accordingly, to the extent

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[5] *See* Section 731 of the Dodd-Frank Act, which imposes various registration and business conduct requirements on SDs and MSPs.

[6] *See* Section 721(a)(21) of the Dodd-Frank Act, which defines the term "Swap Dealer"; *see* Section 721(a)(16) of the Dodd-Frank Act, which defines the term "Major Swap Participant".

[7] EBC I, Inc. v. Goldman Sachs & Co., 5 N.Y.3d 11, 20 (2005) (internal citations omitted), which states that a fiduciary relationship "exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation". Such a relationship, necessarily fact-specific,

that an MSP transacts at arm's-length, we believe the Commission should explicitly clarify that no new duties arise from any aspects of the Proposed Rule.

III. No Imposition of New Duties

Summary: MFA respectfully requests that the Commission explicitly clarify and confirm that the Proposed Rule does not impose any new duties, including duties of disclosure, inquiry, diligence or supervision, other than those that exist or are created by contract, other laws or operation of common law.[8]

Proposed Section 23.402(b) (the "Diligent Supervision Rule") provides that each SD and MSP must diligently supervise their compliance with the requirements of subpart H in accordance with the diligent supervision requirements of subpart J. This requirement is similar to that imposed on FCMs pursuant to the NFA's Supervision Rule.[9] In addition, proposed Section 23.434(a) (the "Suitability Recommendation Rule") provides that each SD and MSP must have a reasonable basis to believe that any swap or trading strategy involving swaps that the SD or MSP recommends to a counterparty is suitable for that counterparty. Further, proposed Section 23.450(b) (the "Qualified Representative Rule") provides that each SD and MSP that offers to, or enters into, a swap with a "special entity" must have a reasonable basis for believing that the "special entity" has a representative that meets certain qualifications enumerated in the Proposed Rule. We believe that without the requested clarification, these rules, if adopted, might impose inappropriate fiduciary and supervisory obligations on MSPs, and in some cases SDs.

MFA is particularly concerned that the Suitability Recommendation Rule would thrust MSPs, and in some cases SDs, into a position of trust and confidence that is not appropriate given that MSPs generally, and in certain circumstances SDs, transact with their counterparties on an arm's-length basis. We believe that, in practice, the Suitability Recommendation Rule would result in MSPs, and in some cases SDs, being subject to a new fiduciary standard that is inappropriate for parties transacting at arm's-length. Because the Proposed Rule does not define the term "recommendation", it therefore, could be overly broad. For example, if an SD or MSP

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is grounded in a higher level of trust than normally present in the marketplace between those involved in arm's-length business transactions. Generally, where parties have entered into a contract, courts look to that agreement "to discover . . . the nexus of [the parties'] relationship and the particular contractual expression establishing the parties' interdependency". "If the parties . . . do not create their own relationship of higher trust, courts should not ordinarily transport them to the higher realm of relationship and fashion the stricter duty for them". However, it is fundamental that fiduciary "liability is not dependent solely upon an agreement or contractual relation between the fiduciary and the beneficiary but results from the relation".

[8] *See also* MFA's letter, dated January 18, 2011 (the "January 18 Letter"), to the Commission regarding RIN No. 3038-AC96: Notice of Proposed Rulemaking on Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants; Notice of Proposed Rulemaking on Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants; Proposed Rule regarding Designation of a Chief Compliance Officer; Required Compliance Policies; and Annual Report of a Futures Commission Merchant, Swap Dealer, or Major Swap Participant. The January 18 Letter also argues that MSPs and SDs should not be subject to fiduciary obligations when transacting at arm's-length.

[9] NFA Compliance Rule 2-9.

is transacting with a counterparty at arm's-length and offers to enter into a swap, such SD or MSP will be working in an environment of legal uncertainty, which could have unforeseen and inappropriate consequences. In such case, it is unclear where the Commission would draw the line between holding a swap out as a possible transaction for a counterparty and recommending such swap to that counterparty. MFA is very concerned that by crossing that line, MSPs transacting at arm's-length will find themselves in a position of having to act in the best interest of the counterparty, which is an obligation that the MSPs may breach by simply taking the other side of the swap.

IV. Increased Costs/Necessity

Summary: To the extent that MSPs are transacting with eligible contract **participants at arm's**-length, we recommend that the Commission not impose unnecessarily **burdensome processes and procedures on the MSP, such as requirements to "know your customer", retain certain records, provide scenario analyses and provide daily marks for** uncleared swaps.

Since certain of the requirements incorporated in the Proposed Rule would require SDs and MSPs to implement new processes and procedures, MFA is concerned that SDs and MSPs will bear substantial costs that are disproportionate to the benefits that their counterparties will receive. For example, the duty to "know your counterparty" and the corresponding recordkeeping requirement,[10] while aimed at achieving laudable goals, are not appropriate to arm's-length transactions. In the current market environment, SDs and MSPs already have incentives to know and understand with which entity they are transacting as a matter of due diligence. Imposing a specific requirement that SDs and MSPs "know their counterparty" and retain a record of such information will require SDs and MSPs to expend substantial resources to obtain and track this information, and we do not see a benefit to the counterparty sufficient enough to outweigh that cost. Accordingly, to the extent that SDs and MSPs are transacting with counterparties at arm's-length, we recommend that the Commission clarify that the requirement to "know your customer" and corresponding record retention requirements do not apply.

Similarly, the duty to provide "scenario analyses" for "high risk complex bilateral swaps"[11] is unnecessary and we believe very costly because SDs and MSPs will have to expend a significant amount of resources to analyze each of their swaps to determine whether such swaps meet this definition. Once SDs and MSPs make such a determination, they will then have to expend additional resources to create "scenario analyses" for each of these swaps. Section 23.431(a) of the Proposed Rule obligates SDs and MSPs to provide disclosure of the material risks, characteristics, incentives and conflicts of interests regarding a swap. Therefore, we do not understand what additional benefits the Commission believes mandated "scenario analyses" will provide to the counterparty that it would not otherwise receive in connection with the disclosure required by Section 23.431(a). Further, the Proposed Rule requires SDs and MSPs to design the

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[10] Sections 23.402(c) and 23.402(h) of the Proposed Rule.

[11] Section 23.431(a)(1)(ii) of the Proposed Rule.

"scenario analyses" in consultation with the counterparty, [12] which means that such analyses may not be prepared for a particular swap and distributed to customers in a general format, but must be personalized for each counterparty to every "high risk bilateral swap". Each step of this process comes with additional costs, and therefore, in its totality will clearly result in substantial cost to SDs and MSPs, while also creating a moral hazard for the counterparty. Since the SD and MSP will be conducting the counterparty's due diligence for them, this requirement creates disincentives for the counterparty to undertake its own due diligence.

Finally, we believe that the duty to provide a daily mark for uncleared swaps also results in significant, unnecessary increased costs. We believe that to the extent that a counterparty needs a mark, it should not rely on the SD or MSP, but instead should seek marks from independent third parties. Therefore, we feel that a better approach would be to allow the parties to negotiate whether and how often SDs and MSPs must distribute this daily mark based on the practical needs and uses of the counterparty.

V. Special Entity Definition

Summary: The Commission **should clarify that the "special entity" definition does** not apply to an investment vehicle, such as a hedge fund, through which a special entity invests.

"Special entity" is defined in Section 23.401 of the Proposed Rule as: "(1) A Federal agency; (2) A State, State agency, city, county, municipality, or other political subdivision of a State or [sic]; (3) Any employee benefit plan, as defined in Section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) [("ERISA")]; (4) Any governmental plan, as defined in Section 3 of [ERISA]; or (v) Any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Internal Revenue Code of 1986 (26 U.S.C. 501(c)(3))." While we believe the statute's plain meaning is well understood, we seek specific clarification that the "special entity" definition does not apply to investment vehicles in which any special entity invests, and that the Commission will not "look through" an investment vehicle to its investors to determine whether the investment vehicle is a "special entity" for the purposes of the Proposed Rule.

If the Commission extends the definition to investment vehicles, the rule as proposed raises a number of additional issues, the most significant of which is that SDs and MSPs will have to expend considerable resources to determine whether such an investment vehicle has any special entities invested, directly or indirectly, in it. In addition, there exists the possibility that the presence of an investment by a special entity in an investment vehicle may make it more costly or even impossible for that investment vehicle to secure a swap as part of its desired investment strategy.[13]

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[12] *Id.*

[13] The Qualified Representative Rule provides that each SD and MSP that offers to, or enters into, a swap with a "special entity" must have a reasonable basis for believing that the special entity has a representative that

In enacting the Dodd-Frank Act, Congress imposed this duty on certain relationships between SDs and special entities to ensure that when SDs are advising special entities appropriate safeguards are in place to protect the special entities.[14] With respect to investment vehicles that have special entities invested in them, there are financially sophisticated and knowledgeable investment advisors that advise and manage those investment vehicles and that owe fiduciary duties to those special entities as investors.[15] As discussed in Section II above, SDs serve as counterparties to these investment vehicles, but do not directly interact with, enter into transactions with, or serve in a position of trust and confidence with respect to those vehicles' investors. Thus, even if special entities invest in these investment vehicles, the relationships between the vehicles and their SD counterparties do not pose the same concerns that are present with respect to direct SD advice to, or interaction with, special entities.

As a result, in such circumstances, raising the costs for or limiting access to swaps would harm the underlying investors in the investment vehicle with no offsetting public benefit. Therefore, we believe that since the investment vehicle is the SD's counterparty, the Commission should not subject SDs to the heightened duties that apply for direct dealings with special entities, and we respectfully urge the Commission to clarify that the "special entity" definition does not apply to any investment vehicle through which a special entity invests.

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meets certain qualifications enumerated in the Proposed Rule. Such an undertaking will require substantial due diligence on the part of SDs and MSPs into the activities of the "special entity" and its representative.

Satisfying this requirement may result in the SD or MSP becoming a fiduciary under ERISA or other applicable law and, because of the existing "prohibited transaction" rules under ERISA or other applicable law, may potentially prohibit the SD or MSP from entering into a swap with the special entity. This outcome would put investment vehicles that have special entity and non-special entity investors in the same vehicle at a competitive disadvantage to investment vehicles that have no special entity investors, and could entirely eliminate the investment options for these investment vehicles. Thus, the Commission should not require SDs and MSPs to question the special entity's selection of a representative that meets applicable requirements (such as a "qualified professional asset manager" or "in-house asset manager" under ERISA).

[14] Senator Blanche Lincoln stated in a floor colloquy that the fiduciary duty that SDs and MSPs must meet when advising special entities "should help protect both tax payers and plan beneficiaries". 156 Cong. Rec. S5293 (daily ed. Jul. 15, 2010).

[15] ERISA Section 3(21)(A) (29 U.S.C. §1002(21)(A)). *See supra*, note 7.

MFA thanks the Commission for the opportunity to provide comments regarding the Proposed Rule. Please do not hesitate to call Carlotta King or the undersigned at (202) 730-2600 with any questions the Commission or its staff might have regarding this letter.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director, General Counsel

cc: The Hon. Gary Gensler, Chairman
The Hon. Michael Dunn, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Jill E. Sommers, Commissioner
The Hon. Scott D. O'Malia, Commissioner