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

August 29, 2011

Via Electronic Submission: http://www.sec.gov/rules/proposed.shtml

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants (RIN 3235-AL10)

Dear Ms. Murphy:

Managed Funds Association ("**MFA**")[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission (the "**Commission**") with respect to its proposed rules on "Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants" (the "**Proposed Rules**"),[2] under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[3] MFA supports the Commission's general approach to establishing business conduct standards with which security-based swap dealers ("**SBS Dealers**") and major security-based swap participants ("**Major SBS Participants**", and together with SBS Dealers, "**SBS Entities**") must comply. The Proposed Rules would increase transparency and promote market integrity by requiring SBS Dealers to provide additional disclosures and protections to customers that are not SBS Entities.[4] MFA members generally consider themselves as financially sophisticated and knowledgeable customers and investors in this market. Given that such counterparties may not need these additional disclosures and protections in their security-based swap trading activities, the Commission should permit such counterparties to opt out of receiving them. We also urge the Commission to make further distinctions between SBS Dealers and Major SBS Participants in the Proposed Rules and not impose dealer-like obligations on Major SBS Participants. Further,

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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 $2.0 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

[2] Release No. 34-64766, File No. S7-25-11, RIN 3235-AL10, 76 Fed. Reg. 42396 (Jul. 18, 2011) (the "**Proposing Release**").

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

[4] Most MFA members are likely not to meet the definitional thresholds of a Major SBS Participant and thus, they would be customers of SBS Dealers. We base our letter on that premise.

we believe that pension plans and other "special entities" would benefit from the Commission's explicit confirmation that the definition of "special entity" does not include investment vehicles in which such entities invest. MFA looks forward to working closely with the Commission to ensure that the final promulgated rules serve the public interest and result in a regulatory regime that imposes appropriate duties on SBS Entities without unnecessarily impeding critical hedging and other risk mitigation trading activity that various market participants must conduct on an ongoing basis.

I. Summary

As a general matter, MFA recommends that the Commission, with respect to the Proposed Rules, consider separate regulatory regimes for SBS Dealers and Major SBS Participants.[5] There are fundamental differences in the businesses, structures and other characteristics of SBS Dealers and Major SBS Participants, and fundamentally different reasons why the Dodd-Frank Act requires additional oversight of each. Therefore, we believe that the Commission should focus regulation of Major SBS Participants on reducing default risk and focus regulation of SBS Dealers on market making and pricing and sales practices, in addition to default risk.

We are concerned that certain aspects of the Proposed Rules are unnecessary in the current market environment or impose prescriptive standards that may result in unwarranted costs. In addition, we are concerned that the "Diligent Supervision" and "Qualified Representative" rules (each as defined in Section III below) may impose new fiduciary obligations or supervisory duties on market participants which are also not warranted. As a result, MFA urges the Commission to reassess the necessity of certain aspects of the Proposed Rules, and we specifically recommend that the Commission:

(i) not subject Major SBS Participants to the same extensive supervisory and compliance structure to which it will subject SBS Dealers;

(ii) clarify that the Proposed Rules do 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) not impose "material information", "clearing rights" and "daily mark" disclosure requirements on Major SBS Participants in arm's-length transactions;

(iv) allow sophisticated counterparties to opt out of receiving additional disclosures provided by certain Proposed Rules that such counterparties do not seek or need; and

[5] The Commission has not yet promulgated final rules defining Major SBS Participant and SBS Dealer, but for the remainder of this letter, when reference is made to either Major SBS Participant or SBS Dealer, it shall mean an entity likely to be included in such category based on the Commodity Futures Trading Commission's ("**CFTC**") and the Commission's current joint proposed definitions.

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

II. Further Distinction between SBS Dealers and Major SBS Participants

Summary: We applaud the Commission for its approach in not applying certain business conduct standards to Major SBS Participants where the Dodd-Frank Act does not expressly address such standards, and we urge the Commission to clarify in the final promulgated rules that a Major SBS Participant acting in the market on an arm's-length basis is not subject to the same counterparty duties to which an SBS Dealer is subject.

A number of the Proposed Rules imply substantial equivalence between a Major SBS Participant and an SBS Dealer with respect to compliance with most of the business conduct standards in the Proposed Rules, but we believe such equivalence is inappropriate in certain cases. Although the Dodd-Frank Act imposes similar obligations on SBS Dealers and Major SBS Participants,[6] it does not state that the Commission must subject SBS Dealers and Major SBS Participants to identical or substantially identical regulation. SBS Dealers and Major SBS Participants are entirely different entities, as the definitions of such terms in the Dodd-Frank Act[7] make clear. Generally, the SBS Dealer definition applies to market makers or others that hold themselves out as dealers to customers, while the Major SBS Participant definition applies to non-dealers with substantial positions in swaps. In the marketplace, entities acting as SBS Dealers are performing sell-side functions where they have duties to their customers, whereas Major SBS Participants are typically trading with dealers and not with customers. Accordingly, to the extent that a Major SBS Participant transacts at arm's-length, we believe the Commission should explicitly clarify that no new duties arise for such a Major SBS Participant from any aspects of the Proposed Rules. We acknowledge that the Commission considered these differences between SBS Dealers and Major SBS Participants and generally chose not to apply certain dealer-linked business conduct standards to Major SBS Participants (*i.e.*, "know your counterparty", suitability obligations for recommendations and "pay-to-play" restrictions) that are not expressly addressed by the Dodd-Frank Act. We agree that Major SBS Participants should not bear such dealer-linked burdens of an SBS Dealer that trades with customers.

In addition, we generally support the Commission's stated rationales for using various self-regulatory organizations' ("**SRO**") business conduct rules as a point of reference in developing the proposed business conduct standards in the Proposed Rules for SBS Dealers.[8]

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[6] *See* Section 764 of the Dodd-Frank Act, which imposes various registration and business conduct requirements on SBS Entities.

[7] *See* Section 761(a) of the Dodd-Frank Act, which defines the terms "security-based swap dealer" and "major security-based swap participant".

[8] *See* Proposing Release at 42399. The Commission's stated rationales are summarized as follows: (i) a number of business conduct standards in Section 15F(h) of the Securities Exchange Act of 1934, as amended (the "**Exchange Act**") appear to be patterned on SRO rules; (ii) such rules have been developed over time with input from market participants; and (iii) since certain SBS Entities are registered broker-dealers and must comply with SRO rules, the SEC's proposed business conduct rules applicable to such SBS Entities should not differ materially

However, we believe that it would be inappropriate for the Commission to impose the same, or substantially the same, standards and duties on Major SBS Participants as those that the Financial Industry Regulatory Authority, Inc. ("**FINRA**") or the National Futures Association ("**NFA**") imposes on broker-dealers ("**BDs**") or futures commission merchants ("**FCMs**"), respectively, and other SBS Dealers. Because a Major SBS Participant's counterparties are typically dealers, a Major SBS Participant would be expected to conduct its business on an arm's-length basis with its counterparties and not act in any advisory role. In such circumstances, the Commission should not hold the Major SBS Participant to a fiduciary standard similar to that of a BD, an FCM or an SBS Dealer that is not acting at arm's-length, because fiduciary duties normally do not arise in situations where the parties conduct business at arm's-length.[9]

III. No Imposition of New Duties

Summary: MFA respectfully requests that the Commission explicitly clarify and confirm that the Proposed Rules do not impose any new duties, including duties of inquiry, diligence or supervision, other than those that exist or are created by contract, other laws or operation of common law.[10]

Proposed Rule 15Fh-3(h) (the "**Diligent Supervision Rule**") provides that each SBS Entity must "establish, maintain and enforce a system to supervise, and shall diligently supervise its business and its associated persons, with a view to preventing violations of the provisions of applicable federal securities laws and the rules and regulations thereunder". In addition, the

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from those imposed by SRO rules and should not introduce inconsistent or competitively disparate requirements based on whether or not an SBS Entity is an SRO member.

[9] 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, 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".

[10] *See also* MFA's letter, dated January 18, 2011 (the "**January 18 Letter**"), to the CFTC 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; and MFA's letter dated February 22, 2011 (the "**February 22 Letter**" and together with the January 18 Letter, the "**CFTC Letters**") regarding RIN No. 3038-AD25: Proposed Rule regarding Business Conduct Standards for Swap Dealers and Major Swap Participants. The CFTC Letters also argue that major swap participants and swap dealers should not be subject to heightened duties or fiduciary obligations when transacting with counterparties at arm's-length. The January 18 Letter is available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27146&SearchText= and the February 22 Letter is available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27782&SearchText=.

Proposed Rules set forth minimum requirements for supervisory policies and procedures that are reasonably designed to achieve compliance with an extensive scope of obligations concerning position limits, risk management procedures, disclosure of information to regulators, conflict-of-interest systems and antitrust considerations.[11] The Commission largely based these dealer-linked supervisory requirements on existing SRO rules applicable to BDs and FCMs.[12]

In addition, Proposed Rule 15Fh-5(a) (the "**Qualified Representative Rule**") provides that each SBS Entity that "offers to enter into or enters into a security-based swap with a special entity must have a reasonable basis to believe that special entity has a qualified independent representative" that meets certain qualifications enumerated in the Proposed Rules. We are concerned that the Qualified Representative Rule, if adopted, would impose additional duties of inquiry and diligence on SBS Entities so that they have sufficient certainty that they can rely upon the representations of a "special entity" or its "qualified independent representative" that those entities meet the necessary criteria or qualifications.

While MFA generally supports the Commission's proposed exception to the Qualified Representative Rule for any security-based swap transaction ("**SB Swap**") with a "special entity" that is executed on a registered security-based swap execution facility or national securities exchange and the SBS Entity does not know the identity of the counterparty, at any time up to and including execution of the transaction, we believe this exception is too limited for certain forms of SBS Swap execution (*e.g.*, request-for-quote) where the time period between the SBS Entity's awareness of the counterparty's identity and the execution of the transaction is too short for the SBS Entity to obtain the requisite factual verifications and representations to comply with the Qualified Representative Rule.

Further, Proposed Rule 15Fh-3(c)(2) (the "**Daily Mark Rule**") would impose on each Major SBS Participant a new duty to disclose to its counterparty the "midpoint between the bid and offer, or the calculated equivalent thereof, as of the close of business, unless the parties agree in writing otherwise to a different time, on each business day during the term" of an uncleared SB Swap. A Major SBS Participant, by definition, is not a dealer, and thus it will not always have the access to sufficient market information to be able to provide a daily market quote. If the particular SB Swap is not actively traded or there are no current bid and offer quotes, which may well be the case for an uncleared, bespoke SB Swap, a Major SBS Participant would have to use its own proprietary mathematical models, quotes and prices of other comparable securities or derivatives to calculate an equivalent mid-market value.[13] While such models may be sufficient to value an SB Swap for purposes of calculating a fund's total asset value, they should not be relied upon by another market participant. In addition to imposing a statutorily mandated duty to disclose a daily mid-market value for each uncleared SB Swap with a non-SBS Entity, the Daily Mark Rule would impose on a Major SBS Participant a duty to disclose, at or before delivery of the first daily mark for an uncleared SB Swap, its data sources and a description of the methodology and assumptions to be used to prepare the daily mark for such SB Swap. In

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11 Proposed Rule 15Fh-3(h)(2).

12 *See, e.g.*, NASD Rules 3010 and 3012; NFA Compliance Rule 2-9.

13 Proposing Release at 42411.

providing daily marks and the required additional disclosures, we are concerned that Major SBS Participants would be at risk of revealing proprietary information about their trading book positions, particularly when providing the methodology and inputs that they used to prepare the daily mark. Disclosure of such proprietary information could thus have adverse competitive effects on Major SBS Participants.

IV. Increased Costs/Necessity

Summary: To the extent that Major SBS Participants are transacting with eligible contract participants ("ECPs")[14] at arm's-length, we recommend that the Commission not impose dealer-like obligations on Major SBS Participants that are unnecessarily burdensome and costly, particularly the requirements to disclose "material information", to provide contemporaneous written records of oral disclosures of material information and clearing rights, and to provide daily marks for uncleared SB Swaps.

Since certain of the requirements incorporated in the Proposed Rules, such as those listed in Section III and in the summary above, would require Major SBS Participants to implement new processes and procedures, MFA is concerned that Major SBS Participants, who currently transact with other SBS Entities and not typically with customers, will bear substantial costs that are disproportionate to the purported benefits that their counterparties will receive or to any overall benefits to the marketplace. If these burdens are not reduced by the Commission in the final promulgated rules, it is likely that most Major SBS Participants will refuse to conduct business with non-SBS Entities after such rules become effective, undermining the development of an all-to-all market, thereby reducing competition and choices for these entities. As most MFA members are likely not to meet the definitional thresholds of a Major SBS Participant, they will face the burden of this reduced competition as customers, with fewer options available to them to conduct business.

More specifically, the Proposed Rules would require Major SBS Participants to make written records of non-written disclosures of material information and clearing rights concerning an SB Swap and to provide these disclosures to their non-SBS Entity counterparties in writing no later than delivery of the trade acknowledgement[15]. This obligation will require Major SBS Participants to expend substantial resources to obtain and track this information quickly and reliably. In circumstances where a Major SBS Participant is entering into an arm's-length transaction with an ECP, such ECP is by definition a sophisticated entity able to evaluate the material risks and other material characteristics of an SB Swap for itself and without receiving disclosures from its Major SBS Participant counterparty. Thus, in such transactions, we do not see a meaningful benefit to the ECP counterparty in an arm's-length transaction sufficient to outweigh that cost. Accordingly, to the extent that Major SBS Participants are transacting with counterparties at arm's-length, we recommend that the Commission not impose the requirements to provide "material information" and deliver contemporaneous written records of non-written

[14] The term "eligible contract participant" means any person as defined in Section 3(a)(66) of the Exchange Act.

[15] Proposed Rules 15Fh-3(b)(3) and 15Fh-3(d)(3).

disclosures of material information and clearing rights on Major SBS Participants. Alternatively, we respectfully suggest that the Commission allow ECP counterparties to opt out of receiving such disclosures to lower their hedging costs and to avoid potential trading delays and inefficiencies.

At a minimum, a Major SBS Participant's duty to provide "material information" should explicitly exclude the provision of SB Swap "scenario analyses". We believe this level of disclosure is unnecessary and very costly since Proposed Rule 15Fh-3(b)(1) would already require Major SBS Participants to undertake a transaction-specific analysis and prepare tailored disclosures of a transaction's loss sensitivities to market factors and conditions and the magnitude of gains and losses the transaction may experience under specified circumstances. In our view, mandating Major SBS Participants to conduct these additional scenario analyses for the benefit of their arm's-length counterparties effectively requires Major SBS Participants to conduct the counterparty's due diligence, thereby creating disincentives for the counterparty to undertake its own due diligence.

In addition, MFA believes that requiring Major SBS Participants to comply with the Daily Mark Rule (described in Section III above) for uncleared SB Swaps also results in significant, unnecessary increased costs without any meaningful benefit.

We believe, moreover, that sophisticated counterparties, such as MFA fund members, should be permitted to opt out of receiving daily marks from their SBS Entity counterparties. As most MFA fund members are likely to be non-SBS Entities, we are concerned that such valuations may be inaccurate or not valid for purposes of preparing their daily net asset value calculations.

MFA is also concerned that the Diligent Supervision Rule (described in Section III above) imposes burdensome and costly supervisory procedures on Major SBS Participants that are not appropriate given their non-dealer role in the marketplace. The imposition of these potential costs would be without any meaningful offsetting benefit for other market participants or the financial markets as a whole.

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 Proposed Rule 15h-2(e) as: "(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) [("**ERISA**")]; (4) Any governmental plan, as defined in section 3(32) 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." 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 Rules.

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 SBS Entities 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 an SB Swap as part of its desired investment strategy.[16] Further, the risk of having a special entity investor may preclude investment vehicles from accepting any investments by special entities, which would severely restrict their investment options.

In enacting the Dodd-Frank Act, Congress imposed this duty on certain relationships between SBS Dealers and special entities to ensure that when SBS Dealers are advising special entities appropriate safeguards are in place to protect the special entities.[17] With respect to investment vehicles that have special entities invested in them, there are financially sophisticated and knowledgeable investment advisers, including many MFA members, that advise and manage those investment vehicles and that owe fiduciary duties to those special entities as investors.[18] As discussed in Section II above, SBS Dealers 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 SBS Dealer counterparties do not pose the same concerns that are present with respect to direct SBS Dealer advice to, or interaction with, special entities.

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[16] For example, the Qualified Representative Rule provides that each SBS Entity that offers to, or enters into, an SB 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 Rules. Such an undertaking will require substantial due diligence on the part of SBS Entities into the activities of the "special entity" and its representative. Without a clear reliance standard with respect to the representations of the special entity or its qualified independent representative, SBS Dealers may opt not to trade with special entities directly, which would effectively prevent special entities from pursuing critical hedging strategies when it would otherwise be prudent and suitable for them to do so.

Moreover, satisfying this requirement may result in the SBS Entity 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 SBS Entity from entering into an SB 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 SBS Entities to question the special entity's selection of a representative that meets applicable requirements (such as a "qualified professional asset manager" or an "in-house asset manager" under ERISA).

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

[18] ERISA Section 3(21)(A) (29 U.S.C. §1002(21)(A)). *See supra*, note 9.

As a result, in such circumstances, raising the costs for or limiting access to SB Swaps would harm the underlying investors in the investment vehicle with no offsetting public benefit. MFA does not believe it is in the interests of our members who serve as investment advisers to these investment vehicles or in the interests of their underlying investors to pay these additional costs or to subject SBS Dealers to a redundant layer of heightened duties to special entity investors when the investment vehicle is the SBS Dealer's counterparty. Accordingly, 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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MFA thanks the Commission for the opportunity to provide comments regarding the Proposed Rules. Please do not hesitate to call Laura Harper 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. Mary Schapiro, Chairman
The Hon. Elisse B. Walter, Commissioner
The Hon. Luis A. Aguilar, Commissioner
The Hon. Troy A. Paredes, Commissioner