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COMMENT
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From: Kang, Miya C. <miya.kang@davispolk.com>
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To: 'rule-comments@sec.gov'; dfadefinitions <dfadefinitions@CFTC.gov>
Subject: File Number S7-16-10 / Definitions
Attach: sifma.amg.definitions.comment.letter.pdf

Attached please find a comment letter on the Advanced Notice of Proposed Rulemaking regarding definitions in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, submitted on behalf of Timothy W. Cameron of the Securities Industry and Financial Markets Association Asset Management Group.

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September 20, 2010

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington DC 20581

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

Re: File Number S7-16-10

Dear Ms. Murphy and Mr. Stawick:

The Asset Management Group (the "**AMG**") of the Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**CFTC**") and the Securities and Exchange Commission (the "**SEC**" and, together with the CFTC, the "**Commissions**") with our comments regarding certain key definitions[2] in the derivatives title ("**Title VII**") of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") and the joint regulation by the Commissions of "mixed swaps."

The AMG's members represent U.S. asset management firms whose combined assets under management exceed $20 trillion. The clients of AMG member firms include, among others, registered investment companies, state and local government pension funds, universities, 401(k) or similar types of retirement funds, and private funds such as hedge funds and private equity funds. In their role as asset managers, AMG member

[1] The Securities Industry and Financial Markets Association brings together the shared interests of more than 600 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

[2] The "key definitions" defined in the Commissions' request for comment include "swap," "security-based swap," "swap dealer," "security-based swap dealer," "major swap participant," "major security-based swap participant," "eligible contract participant" and "security-based swap agreement."

firms, on behalf of their clients, may engage in transactions, including transactions for hedging and risk management purposes, that will be classified as "swaps" and "security-based swaps" (collectively, "**Swaps**") under Title VII of the Dodd-Frank Act.

"Swap Dealers," "Security-Based Swap Dealers," "Major Swap Participants" and "Major Security-Based Swap Participants"

The AMG believes that the statutory definitions of (1) the terms "swap dealer" and "security-based swap dealer" (collectively, "**Swap Dealers**") should be further defined by regulation to exclude market participants that do not perform the traditional functions of dealers and (2) the terms "major swap participant" and "major security-based swap participant" (collectively, "**Major Participants**") should be further defined by regulation to exclude persons who neither have, nor present, a level of exposure to their Swap counterparties that reasonably could be considered to be systemically important or capable of significantly impacting the financial system of the United States. In addition, the Commissions' rules should clarify that it is the entity that is counterparty to Swaps, on an entity-by-entity basis, that may fall within the major swap participant and major security-based swap participant definitions (together, the "**Major Participant Definitions**") and not the asset manager who manages the assets of such entity. Further, the AMG believes that registered investment companies and employee benefit plans subject to the Employee Retirement Income Security Act of 1974 ("**ERISA**") should be excluded by regulation from the Major Participant Definitions.

Swap Dealers should be limited to entities engaging in traditional dealing activities.

The AMG does not believe that Congress intended the swap dealer and security-based swap dealer definitions (together, the "**Swap Dealer Definitions**") in the Dodd-Frank Act to be read to encompass market participants who enter into Swaps as part of investment or hedging strategies but do not engage in the business of dealing in Swaps. The definitions include any person who "regularly enters into [Swaps] with counterparties as an ordinary course of business for its own account." The AMG believes that the term "regularly enters into [Swaps] … as an ordinary course of business" contemplates the regular business of engaging on both sides of the market as a market intermediary and for the purpose of profiting by providing liquidity to counterparties.

The AMG believes that the Swap Dealer Definitions were intended by Congress to operate in a manner similar to the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934 (the "**Exchange Act**") and "futures commission merchant" ("**FCM**") under the Commodity Exchange Act. While the statutory definitions of broker-dealer and FCM are also broadly drawn, the Commissions have, through interpretation, definitional rulemaking and other forms of guidance, clarified the activities leading to registration as a dealer or FCM. For example, typical "dealer" activities have involved the broker-dealer or FCM acting as agent on behalf of clients, or acting as principal where they were in the business of providing liquidity to other market participants or as a market intermediary. For instance, the SEC has issued a series of no-action letters identifying factors that differentiate dealers from traders and, accordingly, most market participants, including active traders, are not required to register as a broker-dealer. In addition, the AMG believes that the statutory creation of the separate categories of "major swap participant" and "major security-based swap participant," which would otherwise be redundant, lends support to our view that the Swap Dealer

Definitions should be similarly limited. Simply put, the AMG believes that the Swap Dealer Definitions should pick up only those institutions that are known in the markets to be dealers of Swaps under the well-established definition of what otherwise constitutes a "dealer."

Members of the AMG manage the assets of funds and other clients that typically enter into Swaps to execute a particular investment or hedging strategy, similar to traders of securities or futures contracts. Because the ordinary business of these clients is financial in nature, it is possible that a strict reading of the plain language of the Swap Dealer Definitions would include them. The AMG does not believe this was the intent of Congress. Accordingly, the AMG believes that the Commissions' rulemaking should clarify that the definitional prong regarding "enter[ing] into [Swaps] … as an ordinary course of business," requires activity on both sides of the market for the purpose of profiting from providing liquidity to counterparties or acting as a market intermediary.

The Commissions should promulgate a clear, objective test for Major Participants based on "aggregate uncollateralized counterparty credit exposure."

Sections 721(a)(16) and 761(a)(6) of the Dodd-Frank Act set forth the Major Participant Definitions. Both of the Major Participant Definitions contain three prongs, each of which looks to the systemic risk posed by a market participant with respect to its Swap activity. In particular, the first and third prongs of each definition look to whether the market participant "maintains a substantial position" in Swaps. Each of the Commissions is required to define "substantial position" for purposes of these prongs "at the threshold that [it] determines to be prudent for the effective monitoring, management, and oversight of entities that are systemically important or can significantly impact the financial system of the United States." The Dodd-Frank Act provides further that "the [Commissions] shall consider the person's relative position in uncleared as opposed to cleared Swaps and may take into consideration the ***value and quality of collateral held against counterparty exposures***." (Emphasis added.) Similarly, the second prong of each definition looks to whether the market participant's outstanding Swaps "create substantial counterparty exposure[3] that could have serious adverse effects on the financial stability of the United States banking system or financial markets."[4]

[3] The AMG reads this to mean an entity's counterparties' exposure to that entity, rather than the exposure the entity itself holds vis a vis its counterparties.

[4] In a Senate Colloquy, Senator Blanche Lincoln stated to Senator Kay Hagan that:

> When determining whether a person has a "substantial position," the CFTC and the SEC should consider the person's relative position in cleared versus the uncleared swaps and may take into account the value and quality of the collateral held against counterparty exposures. The committee wanted to make it clear that the regulators should distinguish between cleared and uncleared swap positions when defining what a "substantial position" would be. Similarly where a person has uncleared swaps, the regulators should consider the value and quality of such collateral when defining "substantial position." Bilateral collateralization and proper segregation substantially reduces the potential for adverse effects on the stability of the market. Entities that are not excessively leveraged and have taken the necessary steps to segregate and fully collateralize swap positions on a bilateral basis with their counterparties should be viewed differently.

The AMG believes that the Commissions should address these considerations by establishing objective quantitative standards. In particular, the AMG recommends a rule providing that no person would be deemed a Major Participant unless that person's aggregate uncollateralized counterparty credit exposure exceeds, on average for any calendar quarter, $2.5 billion with respect to all of such person's counterparties.

"Aggregate uncollateralized counterparty credit exposure" could be defined to mean,

> *with respect to any person on any day, the aggregate amount that such person would owe to its counterparties if such person's entire portfolio of swaps and security-based swaps (other than "foreign exchange swaps" and "foreign exchange forwards,"*[5] *as defined under Title VII of the Dodd-Frank Act)*[6]*, if any, was terminated on such day as a result of the default of such person. For the purposes of calculating such amount with respect to any individual counterparty, the market value of any collateral such person has posted with that counterparty shall be deducted and all applicable contractual netting provisions shall be given effect.*

This definition draws on well-established understandings of how net credit exposure is calculated with respect to over-the-counter derivatives portfolios. It also acknowledges the commercial reality recognized by Congress in the Dodd-Frank Act that collateral decreases the risks to a Swap counterparty and to the financial system as a whole.

The third prong of the Major Participant Definitions focuses on whether a financial entity is "highly leveraged relative to the amount of capital such entity holds." The AMG notes that this prong of the Major Participant Definitions is substantially similar to the first prong of the definitions and that, therefore, the determination of a "substantial position" should focus on uncollateralized positions as discussed above.[7] In this regard, the AMG notes that high leverage, in itself, is not sufficient to cause an entity to be a Major Participant.

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[5] The AMG recommends that the CFTC clarify, through rulemaking, that spot transactions that settle within one customary settlement cycle (typically T+6 or less) do not constitute foreign exchange forwards or swaps.

[6] The AMG has excluded exposures arising from foreign exchange forwards and swaps from this calculation due to the unique characteristics of that market. The AMG notes that under the Dodd-Frank Act, the Secretary of the Treasury may make a written determination that such instruments should be excluded from the definition of "swap." The AMG believes that such an exclusion is appropriate. If it were determined that foreign exchange exposures should be included in the calculation of "aggregate uncollateralized credit exposure," the AMG believes that the Commissions should evaluate the differing characteristics of foreign exchange exposures to determine the extent to which such exposures should be discounted and/or the extent to which an appropriate upward adjustment should be made to the $2.5 billion threshold suggested above.

[7] Unlike the first prong of the Major Participant definitions, the third prong – which applies to highly leveraged entities – does not seem to exclude from the determination of whether an entity has a "substantial position" in Swaps positions maintained (a) for the purpose of hedging or mitigating commercial risk or (b) by an ERISA plan for the primary purpose of hedging or mitigating the operational risk of the plan. Otherwise, the first and third prongs are substantively identical.

The AMG also believes that the Commissions should promulgate objective quantitative standards for determining whether a financial entity is "highly leveraged" for purposes of this third prong. In formulating these standards, the AMG suggests that the Commissions' further rulemaking in determining what constitutes "leverage" should take into account: the difference between non-recourse and recourse obligations; the difference between notional amounts payable and actual payment obligations; and the difference between actual financial obligations of an entity and leverage embedded in a derivative that affects returns but does not result in a payment obligation. Only once the definition of "leverage" has been established can the industry respond to what might be considered to be "highly" leveraged.

The designation of a Major Participant should be determined by reference to the principal counterparty to a Swap; an asset manager should not be required to register as a Major Participant based on Swap activities of its clients.

Members of the AMG believe, for the reasons discussed below, that the Commissions' rulemakings should make clear that an asset manager will not be deemed to be a Major Participant on the basis that it "maintains" positions in Swaps for the accounts of its clients, including the funds it advises.[8] Similarly, the Commissions should ensure that individual clients of an asset manager will not be aggregated in determining that a person maintains a "substantial position" in Swaps.

Focus On Systemic Risk. The AMG believes that the primary goal of regulation of Swap Participants is the reduction of systemic risk. In a Senate colloquy, Senator Kay Hagan indicated to Senator Blanche Lincoln, and Senator Lincoln agreed, that "when the [Commissions] are making the determination as to whether a person dealing in swaps is a major swap participant or major security-based swap participant, it is the intent of the conference committee that both the [Commissions] focus on risk factors that contributed to the recent financial crisis, such as excessive leverage, under-collateralization of swap positions, and lack of information about the aggregate size of positions."[9]

The AMG does not believe that the goal of reducing systemic risk would be served by requiring an asset manager to register as a Major Participant solely because it acts as an agent in transacting Swaps for clients. Asset managers are not the counterparties to the Swaps entered into by their clients, and the exposure and related risk created by Swaps is exposure to and for the clients, not the asset manager. Under this approach, an investment fund that enters into Swaps as principal might be considered a Major Participant, but an investment adviser to the fund, in its capacity as such, would not, simply as a result of its advisory services.

Client-level determination of Major Participant status is supported by the legislative history of Title VII. In a Senate colloquy, Senator Hagan asked Senator Lincoln: "When considering whether an entity maintains a substantial position in swaps,

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[8] The AMG notes that the clarifications the AMG is requesting would not apply to the extent that an asset manager, acting as principal for its own account (rather than on behalf of clients), enters into Swaps and as such, could be viewed as a Major Participant.

[9] The AMG believes that "aggregate size of positions" refers here to the aggregate positions held by a particular counterparty (rather than aggregate positions held by a particular asset manager's clients).

should the [Commissions] look at the aggregate positions of funds managed by asset managers or at the individual fund level?" Senator Lincoln replied that "[a]s a general rule, the [Commissions] should look at each entity on an individual basis when determining its status as a major swap participant."

Certain Regulatory Requirements Applicable to Major Participants are Not Appropriate for Asset Managers. The regulatory regime applicable to Major Participants may fit individual funds and other market participants that maintain substantial positions in Swaps, but is ill-suited to asset managers in their role as advisers. For example, Sections 731(e) and 764(e) of the Dodd-Frank Act require Major Participants to meet certain capital and margin requirements.[10] It would be difficult, if not impossible, to apply these requirements in a meaningful way at the asset manager level, or across multiple clients.

Regulation of Asset Managers as Investment Advisers Makes Additional Regulation as a Major Participant Unnecessary and Duplicative. The Investment Advisers Act of 1940 (the "**Advisers Act**"), as amended by the Dodd-Frank Act, generally requires any asset manager that manages at least $100 million in assets to register as an "investment adviser" with the SEC. The Advisers Act imposes obligations on registered advisers that are similar to many of the requirements that will apply to Major Participants, and gives the SEC significant authority to inspect and examine registered advisers. The AMG submits that Advisers Act regulation further supports the view that it is unnecessary for any registered adviser to be separately regulated as a Major Participant. For example, registered investment advisers are, or will become, subject to the following requirements, among others:

- As a result of the Dodd-Frank Act, advisers to private funds will be required to comply with the Advisers Act's obligations to maintain records and reports regarding each private fund advised by the adviser that include: (i) amount of assets under management, (ii) use of leverage, (iii) counterparty exposure, (iv) trading and investment positions, (v) valuation policies and practices, (vi) types of assets held, (vii) side arrangements or side letters, (viii) trading practices and (ix) other information deemed by the SEC, in consultation with the Financial Stability Oversight Council, to be necessary and appropriate in the public interest, and for the protection of investors or for the assessment of systemic risk.[11]

- The Dodd-Frank Act requires the SEC to promulgate rules requiring each investment adviser to a private fund to file reports containing such information as the SEC deems necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

[10] Capital and margin requirements are established by the prudential regulator of those entities that have a prudential regulator, and are established by the Commissions for those entities that do not have a prudential regulator.

[11] Registered investment advisers were already subject to many of these requirements even prior to the passage of the Dodd-Frank Act.

- The Dodd-Frank Act modified the prior Advisers Act prohibition limiting the SEC's ability to require investment advisers to disclose the identity, investments or affairs of their clients by adding an exception enabling the SEC to require the disclosure of such information for purposes of assessment of potential systemic risk.

- All records of private funds maintained by a registered investment adviser, not just those required to be maintained by law, will be subject to periodic and special examination by the SEC.

- A registered investment adviser must appoint a chief compliance officer, establish a compliance program and a code of ethics and comply with custody and recordkeeping requirements. An adviser is also subject to examination and inspection by the SEC.

The Major Participant Definitions should exclude registered investment companies and employee benefit plans subject to ERISA. Such entities are already highly regulated, and regulation as a Major Participant would impose inconsistent, unnecessary and duplicative requirements.

Many AMG members are advisers to investment companies registered under the Investment Company Act of 1940 (the "**Investment Company Act**") and employee benefit plans subject to ERISA. Under these regimes, the activities of registered funds and ERISA plans – including transactions in Swaps – are subject to robust regulation. Additional regulation as a Major Participant is unnecessary and would likely impose conflicting or redundant requirements on such entities.[12]

The AMG believes that excluding such entities from regulation as a Major Participant is consistent with Congressional intent. In a Senate colloquy, Senator Blanche Lincoln stated that:

> it may be appropriate for the CFTC and the SEC to consider the nature and current regulation of the entity when designating an entity a major swap participant or a major security-based swap participant. For instance, entities such as registered investment companies and employee benefit plans are already subject to extensive regulation relating to their usage of swaps under other titles of the U.S. Code. They typically post collateral, are not overly leveraged, and may not pose the same types of risks as unregulated major swap participants.

[12] While "positions maintained by any employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002) for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan" are explicitly carved out of the determination of whether a market participant maintains a "substantial position" in Swaps for purposes of the first prong of the Major Participant Definitions, the AMG believes that the further definition of these terms by the Commissions should clarify that pension plans are explicitly excluded from all three prongs of the definitions.

Registered Investment Companies

Registered funds are subject to significant requirements and restrictions relating to their investments, capital structure and governance, which obviate the need for such funds to be regulated as Major Participants.[13]

Restrictions On "Senior Securities." The Investment Company Act significantly restricts a registered fund from issuing "senior securities." Under longstanding interpretations of the SEC and the staff of the SEC's Division of Investment Management, many derivative instruments that create explicit or implicit leverage are deemed prohibited as the issuance of a senior security, unless the registered fund (i) segregates or earmarks cash, liquid securities or other liquid assets on its books at its custodian in an amount that, together with amounts deposited as margin, is at least equal to the fund's obligation under such instrument, and marks to market daily, or (ii) holds an offsetting position.[14] This requirement has the effect of limiting the leverage that a registered fund can undertake via Swaps and other derivatives, and makes it unlikely that a fund's investments in such transactions will create significant systemic risk.

Limits on Investments in Securities-Related Issuers. A registered fund may not invest more than 5% of its total assets in the securities of any single "securities related issuer."[15] A securities related issuer is any issuer that has derived more than 15% of its gross revenues from activities as a broker, dealer, underwriter or investment adviser in its most recent fiscal year. As a result of this requirement and other considerations, the AMG believes that most funds structure their investments in Swaps so that the fund's exposure to any single counterparty generally does not exceed 5% of the fund's total assets. Such counterparty diversification significantly reduces the risk that a fund's Swap exposure will give rise to systemic risk.

Limits on Illiquid Investments for Open-End Funds. Open-end registered funds, which issue securities that are redeemable daily, may not invest more than 15% of their assets in instruments that are "illiquid."[16] The SEC generally views an instrument as

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[13] The AMG notes that the use of Swaps and other derivatives by registered investment companies has been an area of focus for the SEC. The Division of Investment Management of the SEC has been studying how registered investment companies use derivatives, including Swaps, and the manner in which such derivative use is regulated. In April 2009, the head of the Division proposed that the Subcommittee on Investment Companies and Investment Advisers of the American Bar Association's (ABA) Section of Business Law's Committee on Federal Regulation of Securities conduct a study of such matters, and in response, the ABA created a Task Force on Investment Company Use of Derivatives and Leverage. The Task Force released a report with its recommendations on July 6, 2010 (the "**Task Force Report**"), which is available at http://www.abanet.org/buslaw/blt/content/ibl/2010/08/0002.pdf.

[14] *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 18, 1979); Merrill Lynch Asset Management, L.P., SEC No-Action Letter, 1996 WL 429027 (July 2, 1996); Dreyfus Strategic Investing and Dreyfus Strategic Income, SEC No-Action Letter, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 48,525 (June 22, 1987).

[15] *See* Section 12(d)(3) of the Investment Company Act and Rule 12d3-1 thereunder.

[16] The 15% limit on illiquid securities is derived from Guide 4 of the Guidelines to Form N-1A. The Guidelines were officially repealed by the SEC in 1998; however, open-end funds have continued to comply with the 15% limit.

illiquid if it cannot be disposed of by the fund in the ordinary course of business within 7 days at approximately the value at which the fund values the instrument for purposes of calculating its NAV.[17] This requirement effectively limits the amount of an open-end fund's assets in Swaps that may be illiquid or difficult to value.

Disclosure, Valuation and Reporting Requirements. Registered funds are required to calculate and publish their NAV. They must also disclose substantial information about their investment strategies, including use of Swaps and other derivatives, and file quarterly reports with the SEC that include their portfolio holdings, including swaps and security-based swaps.[18] Such reporting leads to greater transparency into a fund's investments in Swaps and increases the ability of counterparties and regulators to provide oversight and assess risk.

Compliance Oversight. Registered investment companies are required to adopt and maintain substantial compliance programs, designed to assure compliance with the foregoing requirements. Among other things, a registered fund is required to adopt policies and procedures to prevent violations of the U.S. securities laws, appoint a Chief Compliance Officer who is responsible for administering the fund's policies and procedures and maintain extensive books and records. A registered fund's Board of Directors must approve the compliance policies and procedures of a fund and any investment adviser to the fund and annually review such policies and procedures (such review includes a report to the Board by the fund's Chief Compliance Officer). The oversight role of the Board is strengthened by the requirement that a majority of the Board cannot be "interested persons" of the fund.

Board Oversight of Derivatives. The SEC Staff has indicated that directors of registered funds play a critical role in overseeing registered funds' use of derivatives. For example, the Associate Director of the Office of Compliance Inspection and Examinations at the SEC indicated in a speech that registered fund directors should focus on the following factors, among other things, when investing in derivative products: (i) the capacity of the fund's investment risk management function to regularly identify, measure, evaluate and manage the fund's ongoing risk exposure; (ii) the effectiveness of the process used to measure the liquidity of the fund's portfolio to ensure that the fund's ongoing liquidity needs can be met; (iii) the capacity of the fund's process for effectively defining and evaluating embedded or economic leverage associated with the fund's positions in derivatives to effectively ensure that the fund's exposure to leverage is within statutory limits and consistent with disclosures made to shareholders; (iv) the effectiveness of the fund's management of material compliance risks relating to the fund's investments in derivatives; and (v) the effectiveness of the fund's Chief Compliance Officer in monitoring and overseeing the fund's exposure to derivatives and the concomitant risks.[19]

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[17] An open-end fund's Board of Directors may impose additional restrictions on the ability of the fund to invest in illiquid instruments.

[18] Although portfolio information is generally disclosed on a delayed basis, such reporting still provides transparency into a registered fund's use of Swaps.

[19] Gene Gohlke, Assoc. Dir., U.S. Sec. and Exch. Comm'n Office of Compliance, Inspection and Examinations, If I Were a Director of a Fund Investing in Derivatives – Key Areas of Risk on Which I

(…continued)

The AMG believes that the substantial compliance requirements and supervision to which registered funds are subject, combined with the restrictions and requirements relating to a fund's investments described above, make regulation as a Major Participant unnecessary and the Senate colloquy referenced herein provides strong indication that Congress did not intend such a result. Such regulation would only impose further compliance and related costs on registered funds, which would ultimately be borne by the investors in such funds without providing any material benefit in reducing systemic risk.

Plans Subject to ERISA

ERISA plans and governmental benefit plans are subject to an exclusion found in the first prong of the Major Participant Definitions under the Dodd-Frank Act and most commentators who followed the legislation have assumed that such plans are per se excluded from these definitions. This appears to have been the intent of Congress, but, as with a number of provisions of the Dodd-Frank Act, this is not entirely beyond doubt. Accordingly, regulatory clarification would be helpful. At a minimum clarification is required as to the operative words of the exclusion which excludes "positions maintained by any employee benefit plan … *for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan*." Under ERISA and general fiduciary principles, the fiduciaries of a plan are required to invest the plan's assets strictly in a manner intended to meet benefit payment obligations under the plan. Accordingly, all investment activity undertaken by a plan in accordance with ERISA is for the primary purpose of hedging the risks and liabilities associated with the benefit obligations under the plan. Regulations should address this point by clarifying that any Swaps undertaken by a plan in accordance with the fiduciary requirements of ERISA will be deemed to be for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan.

More generally, the rules of the Commissions should make clear that benefit plans are intended to be generally excluded from the Major Participant Definitions, based on the legislative history and the extensive, long-standing regulatory regime governing plans and the unique structure and financial transparency of plans.

Prudence and Diversification. ERISA plans are subject to statutory and regulatory requirements requiring the assets of such plans to be prudently diversified. ERISA is based, in part, on the premise that participants may not benefit from retirement assets if a plan has all of its "eggs in one basket." ERISA therefore requires a plan to diversify the investments of the plan "so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so." In addition, ERISA requires plan investments to be managed with the care, skill, prudence and diligence that a prudent expert would apply to a portfolio that is intended to accumulate assets to meet benefit obligations. These ERISA requirements have repeatedly been acknowledged by courts and regulators as the highest standards of prudence and diversification known to the law.

(continued…)

Would Focus, Speech at Mutual Fund Directors Forum Program (Nov. 8, 2007), *available at* http://www.sec.gov/news/speech/2007/spch110807gg.htm.

Professional Management. Underscoring the critical focus that ERISA places on having investment decisions made by experienced investment professionals, ERISA requires that investment decisions be made with the skill and care of a "prudent expert." Assets of ERISA plans are therefore typically managed by registered investment advisers, banks and state regulated insurance companies. These managers are subject both to ERISA (including diversification and prudence requirements) and their own relevant regulatory regime. The penalties for failing to satisfy ERISA's high standard of care are strict and extreme. Advisers can also be held liable for the acts of other fiduciaries.

Trust Overlay. ERISA plan investments must be held in trust, subject to the oversight of an institutional trustee, most commonly a bank or similar entity, again regulated by a prudential regulator. At a minimum, the trustee is responsible for the safe keeping of the plan's assets. Trustees may also in certain circumstances be subject to co-fiduciary liability for breaches by other plan fiduciaries.

Unleveraged Asset Pool. ERISA plans are unleveraged asset pools. While plans may engage in some leveraged investing and short strategies, ERISA plans are managed under modern portfolio theory with the focus on maximizing plan returns with low volatility of the plans' portfolios. Therefore, the preponderance of plan assets are typically invested in long, unleveraged positions in various traditional asset classes with a view to asset accumulation and preservation to meet long-term benefit liabilities.

Transparency. ERISA plans typically can and do regularly report their net asset and financial position to derivative dealers with whom they transact. ISDAs with plan counterparties will often contain ERISA-specific reporting, early termination or event of default provisions that provide early warning signals, credit enhancement or early termination rights in the event that a plan exceeds specified volatility threshold difficulties (e.g., a decline in a plan's net assets below an specified absolute dollar amount or, in the alternative, a decline below a percentage of such net assets as measured in the prior month, quarter or year). ERISA plans also report their assets and financial positions annually in filings with the U.S. Department of Labor. These filings are often publicly available.

No Operating Risks. ERISA plans are asset pools held separately and remotely from the companies that sponsor such plans. As such, the asset pools are not subject to the business line and balance sheet risks typical of operating companies. Under ERISA, plans are subject to strict rules that require the sponsoring employer to fund the plan on at least an annual (and, in many cases, quarterly) basis. Failure to meet minimum funding requirements can have severe consequences for all members of the sponsor's controlled group.

No Avoidance of Obligations Under Investments. Because ERISA plans are asset pools and not operating companies, there is no provision for bankruptcy of a plan under bankruptcy law. Even in the case of a termination or liquidation of an ERISA plan, including when a plan has been taken over by the PBGC, obligations to derivatives counterparties of the plan are required to be settled out of the general assets of the plan before the plan can make payouts to the plan's participants and beneficiaries. Termination events under a Swap contract with a derivatives dealer will also typically include an amendment to the plan's governing documents that could provide for the incurrence of indebtedness or other obligation that would rank senior to the obligations of the plan under the Swap agreement.

Stable Asset Base. Defined benefit plans are stable and relatively static long-term asset pools and are not subject to withdrawals or transfers in the same manner as hedge funds or similar investment vehicles experience.

Secure Credit. Dealers typically treat plans as triple A credits for purposes of financial transactions.

Although benefit plans sponsored by U.S. federal, state and local governments are not technically subject to ERISA, based on other applicable rules and principles, governmental plans are subject to many of the same requirements and constraints applicable to ERISA plans. Any treatment applied to ERISA plans under regulations should apply equally to governmental plans. Further, to the extent a pension plan subject to the pension law regulations of Canada, the United Kingdom or the European Union enters into a swap in the United States for the primary purpose of hedging or mitigating any risk associated with the operation of the plan, such plan's position should qualify by regulation for the same exclusion. Each of such jurisdictions has extensive pension law regulations and the policy reasons behind the exclusion for U.S. pension plan swap positions which are "for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan" are, in our view, equally applicable to pension plans operating in such jurisdictions.

"Mixed Swaps"

The scope of products regulated as "mixed swaps" should be clarified, and the mixed swap regulatory regime should avoid duplicative regulation.

The AMG believes the joint regulations promulgated with respect to "mixed swaps" should limit the scope of products that fall into this category to avoid unnecessary and duplicative regulation. In particular, the AMG believes that the Commissions should promulgate rules that would impose a predominance test on mixed swaps such that a security-based swap that has only incidental or *de minimis* characteristics of a swap would be treated as a security-based swap, and that a swap that has only incidental or *de minimis* characteristics of a security-based swap would be treated as a swap.

For example, the primary purpose of many "plain vanilla" equity swaps is to transfer from one counterparty to the other economic risk with respect to the underlying equity asset. The party that is "synthetically long" the underlying asset is in a position that is economically similar to having borrowed the notional amount of the swap from its counterparty to invest in the underlying asset. In fact, it is typical in the over-the-counter equity derivatives market for one party to hedge its exposure under the equity swap by acquiring a hedge position in the underlying asset. To compensate this party for its required use of capital, these transactions may contain a "financing leg" which obligates the synthetically long counterparty to make a payment calculated as the notional amount multiplied by a LIBOR-based or other variable interest rate. This financing component is merely incidental to the transaction. In fact, the value of a swap for margin and capital purposes is based only on the equity price of the underlying asset and does not change based on movements of the interest rate. The AMG believes that a financing component of a "security-based swap" should not cause such transaction to be viewed as a "mixed swap."

In addition, Section 712(a) of the Dodd-Frank Act requires the Commissions to jointly regulate "mixed swaps," but that does not mean that they should be subject to two sets of rules. The AMG believes that, as a matter of regulatory efficiency and legal certainty, it should be a fundamental principle that, whenever possible, transactions should be regulated under a single set of rules. As a result, the AMG believes that the regulatory system put in place by the Commissions for mixed swaps should reflect the specific nature of these products, rather than simply a system by which "mixed swaps" are doubly regulated as "swaps" by the CFTC and "security-based swaps" by the SEC. For example, to avoid unnecessary and costly regulatory duplication, the AMG suggests that the Commissions jointly develop a single form for reporting of information related to mixed swaps.

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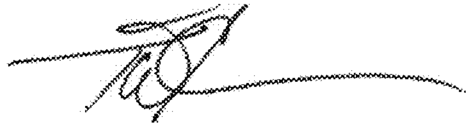
The AMG thanks the Commissions for the opportunity to comment in advance of their joint rulemaking on further definition of the key terms and the regulation of mixed swaps and for the Commissions' consideration of the AMG's views. The AMG's members would appreciate the opportunity to further comment on these topics, as well as other rulemakings the Commissions will undertake under Title VII of the Dodd-Frank Act. If you have any questions, please do not hesitate to call either Daniel N. Budofsky, Davis Polk & Wardwell LLP, at 212-450-4907 or the undersigned at 212-313-1389.

Sincerely,



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