BLACKROCK

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<u>Via electronic submission to: comments.cftc.gov</u>

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

Re: <u>Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties; RIN Number 3038-AD25</u>

Dear Mr. Stawick:

BlackRock, Inc.[1] is pleased to offer its comments on the Commodity Futures Trading Commission's ("CFTC") proposed rule (the "Proposed Rule")[2] under Section 4s(h) of the Commodity Exchange Act ("CEA") to implement provisions of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") relating to business conduct standards for swap dealers ("SDs") and major swap participants ("MSPs")[3] with counterparties. Our overarching concern is that proposals that we believe were designed to protect the interests of many of our clients may actually adversely affect the interests of our clients.

The Proposed Rule is intended to implement among other things Congress' directive that SDs and MSPs verify the eligibility of their counterparties; disclose to their counterparties material information about swaps, including material risks, scenario analysis, material characteristics, material incentives and conflicts of interest; and provide counterparties with information concerning the daily mark for swaps. The Proposed Rule is also intended to establish a duty for SDs to communicate in a fair and balanced manner based on principles of fair dealing and good faith.

The Proposed Rule goes beyond the mandatory requirements of the Dodd-Frank Act as the CFTC has used its discretionary authority to add additional responsibilities, including an institutional suitability requirement and execution standards. We share the CFTC's goal of

1 BlackRock is one of the world's leading asset management firms and manages over $3.54 trillion on behalf of institutional and individual clients worldwide through a variety of equity, fixed income, cash management, alternative investment, real estate and advisory products. Our client base includes corporate, public, multi-employer pension plans, insurance companies, third-party mutual funds, endowments, foundations, charities, corporations, official institutions, banks, and individuals around the world.

2 75 Fed. Reg. 245 (December 22, 2010). Capitalized terms used, but not otherwise defined, shall have the meanings in the Proposed Rule.

3 We note that the definition of MSP is only proposed with a comment period that closes simultaneously with the comment period for the Proposed Rule. *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174 (Dec. 21, 2010). This raises concerns, expressed previously by BlackRock and other industry participants, that it is difficult to provide meaningful comment when those most likely to be affected by a rule are unable to ascertain whether they are subject to it.

improving disclosure and other practices involving swap transactions. However, we are concerned that the Proposed Rule alters the nature of the relationship between SDs, MSPs and their counterparties (and when the counterparty is a Special Entity[4], among the SD, the Special Entity and its independent representative) and creates confusion regarding the responsibilities of each such party. Further, the Proposed Rule evidences a fundamental misunderstanding of certain market practices and effectively imposes fiduciary status on SDs and MSPs, a result that was expressly rejected by Congress in adopting the Dodd-Frank Act.[5]

We believe at this time the CFTC should not adopt business conduct standards beyond those mandated by Congress. Once other requirements of the Dodd-Frank Act have been implemented, including the trading of swaps on swap execution facilities ("SEFs"), and the CFTC has gained more familiarity with the swaps marketplace and its practices, it then may be appropriate for it to consider changes to the standards.

The Proposed Rule also illustrates the need for the CFTC to craft separate regulatory regimes that are specifically applicable to SDs and MSPs. By definition, SDs are entities that make markets in swaps or sell swaps to others, and MSPs are defined as parties that are <u>not</u> SDs, yet maintain swaps positions with sufficient exposures to create systemically important default risk. MSPs are therefore those entities commonly known as the "buy-side" of the swaps market. By equating MSPs with SDs, the Proposed Rule turns the business conduct standards, which were proposed by Congress to protect the buyer of a swap from the seller, on their head. Instead of protecting the buyer from its SD, the CFTC's proposal effectively requires the buyer to protect the SD. This is surely not what the Dodd-Frank Act intended to achieve.

Moreover, as the CFTC is aware, there are several other regulatory projects underway which involve financial services firms and their role in providing services or advice. In particular, the United States Department of Labor (the "DOL") has proposed a new rule setting forth the circumstances under which a person is considered to be a "fiduciary" for purposes of ERISA, by reason of providing investment advice to an employee benefit plan subject to ERISA ("Plan") or a Plan's participants and beneficiaries ("Proposed Fiduciary Definition").[6] It is critical that the CFTC coordinate with the DOL, so that Plans, which are included in the definition of Special Entity under the Proposed Rule, will not be precluded from entering into swaps.[7]

Last, the Proposed Rule raises a number of concerns about the legal and administrative feasibility of SDs and MSPs entering into swap transactions with non-SD/MSP counterparties—the vast majority (if not all) of our clients.[8] These instruments are an

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4 The Dodd-Frank Act defines "Special Entities" to include government agencies, any employee benefit plans under the Employee Retirement Income Security Act of 1974 ("ERISA"), any governmental plan, endowments and municipalities.

5 During the House-Senate conference, Congress struck a provision from the Senate version of H.R. 4173 that would have imposed a fiduciary duty on a dealer entering into a swap as a counterparty to a defined category of entities, including employee benefit plans.

6 75 Fed. Reg. 204 (Oct. 22, 2010).

7 The sole reference in the preamble to the Proposed Rule is a statement that the CFTC staff has consulted with DOL staff, who advised that any determination of status under the Dodd-Frank Act is separate and distinct from the determination of whether an entity is a fiduciary under ERISA. While it is true that there are separate rules, it is essential that it be possible for Plans to comply with both sets of rules so that they are not precluded from entering into swaps.

8 A significant number of BlackRock clients fall within the statutory definition of Special Entities, as "employee benefit plans," "governmental plans," states, cities, or endowments. (*See* CEA Section 4s(h)(2)(c)). However, as discussed elsewhere in this letter, the definition of Special Entity needs clarification. In addition, as noted above, until the definitional rule for MSPs is finalized, it will not be possible to know if any of our clients fall within that classification.

important part of investment strategies that are designed to manage liability risks and to enhance returns. BlackRock believes that if the Proposed Rule were enacted in its present form, it would harm, not protect, our clients' ability to transact in the swaps market. We do not believe this was the intent of Congress in adopting business conduct standards for SDs and MSPs.

Although the Proposed Rule has many unintended consequences for SDs, BlackRock, as a leading asset manager to a variety of investment funds and accounts, has limited its comments on the Proposed Rule to those that would have an adverse impact on our clients or affect negatively our asset management services.

I. *The Obligation of the SD to Assess the Qualifications of Independent Representatives is Unnecessarily Intrusive and Inhibits Special Entity Choice.*

As an asset manager, BlackRock expects that it will often fulfill the role of independent representative for its Special Entity clients. For SDs that "offer to" or enter into a swap with a Special Entity, the Proposed Rule requires that the SD/MSP assess the qualifications of the Special Entity's independent representative as well as certain aspects of the relationship between the Special Entity and its representative.

BlackRock is proud to be a fiduciary for our clients, yet we find the Proposed Rule comes close to having the SD "approve" the Special Entity's independent representative. It also confuses the role of the SD, who, absent an advisory relationship, is engaging in an arms-length transaction with its counterparty, and should not be called upon to evaluate the experience and capabilities of the Special Entity's independent representative with whom the SD must negotiate.

While the Proposed Rule permits reliance on written representations by the Special Entity, this provision is qualified by requiring that the SD take into consideration the facts and circumstance of a particular Special Entity-representative relationship, assessed in the context of a particular transaction. This approach will likely result in protracted negotiations regarding the language of the required representations, particularly considering the requirement that the representations be reasonably detailed and the lack of clarity in the Proposed Rule as to the scope of those representations. At a minimum, this will likely increase costs for the Special Entity and result in delayed execution of the corresponding swap and extended periods of market risk.

We believe the Special Entity is best-situated to selecting and evaluating the qualifications of its own representative. The CFTC should specifically permit the SD to rely, absent notice of facts that would require further inquiry, on simple representations of a Special Entity as to the qualifications of its chosen representative. Further, we believe that for Special Entities that are ERISA plans, the representation should be limited to a statement that the representative is, and has acknowledged to the Plan that it is, a fiduciary under Section 3 of ERISA, and qualifies as a qualified professional asset manager within the meaning of Prohibited Transaction Class Exemption 84-14 (the "QPAM Exemption") or as a qualified in house asset manager within the meaning of Prohibited Transaction Class Exemption 96-23.

II. *The Proposed Rule Establishes a New Standard of Independence that is Unnecessary and Unworkable in Practice.*

Section 23.450(c) of the Proposed Rule imposes an independence definition on representatives of a Special Entity. This three part test requires that (i) the representative is not and was not within the previous year an associated person of the SD/MSP, (ii) there is no principal relationship between the SD/MSP and the representative and (iii) there is no "material business relationship" between the SD/MSP and the representative, whether or not compensatory, including any relationship that "reasonably could affect the independent judgment of the representative" (also with a one-year look back).

This definition of independence is different than other well-established and workable tests of independence set forth in the Securities Act of 1933 or ERISA (as discussed below). We are concerned that yet another test to be understood and followed by SDs will discourage them from transacting with Special Entities. We respectfully urge the CFTC to adopt the tests used under the Securities Act and ERISA to avoid confusion and inconsistency.

We believe the scope and meaning of "material business relationship" must be clarified in any final rules the CFTC adopts. Financial institutions have multiple business lines with potentially multiple relationships for many of their clients. For example, an asset manager may trade securities through the broker affiliate of the SD; use an affiliated broker dealer as distributor/underwriter for mutual funds managed by the asset manager; or license an index from an affiliate of the dealer. An overly broad definition of material business relationship will preclude the Special Entity from retaining numerous qualified representatives.[9]

With respect to Plans relying on the QPAM Exemption in entering into a swap, this new independence requirement would need to be satisfied in addition to the independence requirements contained in the DOL-imposed, ERISA-based QPAM Exemption. In our view if the requirements of the QPAM Exemption are satisfied with respect to a swap entered into on behalf of a Plan, the separate independence requirements in the Proposed Rule should not apply. The multiple rules that are designed to achieve a similar purpose will only increase the administrative burden of compliance with the Proposed Rule, without any corresponding benefit.

As part of the "material business relationship" determination, the Proposed Rule requires that the representative disclose compensation received in the prior year from the SD or MSP. As drafted, the disclosure does not appear to require a nexus between the compensation that must be disclosed to the Special Entity and the particular swap transaction. As noted above, qualified and experienced representatives are likely to have multiple relationships with financial services firms that have SD affiliates. A requirement to survey all business relationships with a representative to determine whether any compensation was paid, and if so, what compensation was paid, would be extremely burdensome and provide little or no benefit to the Special Entity. The CFTC should clarify that no disclosure is required of compensation except with respect to the particular swap transaction at issue.

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9 It is difficult to square the experience and qualification requirements of the representative set forth in proposed Section 23.450 with a broad definition of independence, as the most qualified representatives are likely those actively engaged in providing consulting, risk management or asset management services to multiple clients. This will necessarily create multiple business relationships with financial institutions, many of which will have dealer affiliates.

III. *The Requirements Applicable to Swap Dealers Acting as Advisors to Special Entities Could Preclude Plans from Entering into Swaps and/or Significantly Complicate and Delay Execution of Transactions.*

In acting as an ERISA fiduciary, we and other asset managers frequently recommend and negotiate swaps and other derivatives on behalf of our Plan clients. The self dealing prohibitions in Section 406(b) of ERISA preclude Plans from engaging in principal transactions, including swaps, with entities that act as fiduciaries with respect to the Plan's assets involved in the transaction. Section 23.440 of the Proposed Rule requires that, when a SD provides advice regarding a particular swap or trading strategy involving the use of swaps to a Special Entity, including Plans, it must act in the "best interests" of the Special Entity. Section 23.440(a) broadly defines advice to include situations where a SD recommends a swap or trading strategy that involves the use of swaps to a Special Entity. The requirement that the SD act in the "best interests" of the Plan when providing a recommendation would likely result in the SD being considered a fiduciary and likely effectively preclude Plans from entering into swaps with that SD. Indeed, in the preamble to the Proposed Rule, the CFTC stated that it would not define "best interests", noting that "there are established principles in case law which will inform the meaning of [best interests]" and included a footnote citation to ERISA.[10]

The requirement that the SD/adviser act in the best interests of a Special Entity also confuses the roles of the parties and will have an adverse impact on the flow of information regarding investment and trading strategies. Special Entities engage independent representatives to develop investment strategies and to provide advice and make decisions regarding the swaps that will best enable them to achieve their investment objectives. Independent representatives, such as BlackRock, embrace this role and its heightened responsibilities. The SD, by contrast, is transacting with the Special Entity on an arm's length basis, on the other side of the transaction, and is not acting as an investment manager or adviser to the Special Entity. However, in fulfilling their mandates, independent representatives will often exchange information and ideas with the SD on how to best achieve the Special Entity's investment objective. If SDs are obligated to act in the best interests of Special Entities, this could cause them to refuse to provide any recommendations or assistance in structuring a particular transaction out of concern that the recommendation could later be considered not in the "best interests" of the counterparty. Such a refusal could have an adverse impact on the ability of a Special Entity to optimize its investment return or most effectively achieve its investment strategy.

We recommend that the requirement that a SD/adviser must act in the best interests of a counterparty be deleted from the regulation. Asset managers, such as BlackRock, are fully capable of assessing whether a swap is in the best interests of its clients, including Special Entities. At a minimum, the requirement that the SD act in the best interests of a Plan and that it make reasonable efforts to obtain information that is necessary to make the determination that the swap is in the best interests of the Plan should not apply when the Plan (or other Special Entity) is represented by an investment adviser, such as BlackRock, that is acting as a "qualified professional asset manager" within the meaning of the QPAM Exemption and the documentation otherwise reflects that the Plan, or other Special Entity, does not regard the counterparty as a fiduciary. In addition, the CFTC should specify that it does not intend that its Proposed Rule will cause a SD to be considered an ERISA fiduciary. The CFTC should work closely with the DOL as it develops its Proposed Fiduciary Definition to ensure that compliance with the Proposed Rule does not result in fiduciary status under ERISA.

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[10] *See* 75 Fed. Reg. at 80652.

Furthermore, Section 23.440(c) of the Proposed Rule, which permits the SD to rely on reasonably detailed representations of the Special Entity, will likely result in protracted negotiations regarding the language of those representations and delay in swap execution. The additional requirement that the SD have a reasonable basis to believe that representations are reliable, taking into consideration the facts and circumstances of a particular Special Entity, will likely result in the SD seeking additional diligence (generating much discussion regarding the scope of diligence) from the Special Entity and its independent representative. These required representations and the associated diligence will impose an additional burden and cost on Special Entities without any corresponding benefit. The reason the Special Entity hired the independent advisor is so that the independent representative would make the investment decisions regarding appropriate swaps. We believe that these additional representations and diligence are unnecessary and should be omitted from the Proposed Rule.

IV. *Scenario Analysis, Daily Mark and Suitability Requirements Should Not Make the SD an ERISA Fiduciary.*

In addition to the requirement to act in the "best interest" of a Special Entity when providing advice, several additional provisions of the Proposed Rule could result in counterparties to Plans being considered ERISA fiduciaries under the Proposed Fiduciary Definition, the DOL's existing rule defining when the provision of investment advice will cause a Plan service provider to become a fiduciary,[11] or both. As set forth above, if compliance with the Proposed Rule results in a SD being considered an ERISA fiduciary, that could preclude the Plan from entering into the swap.

BlackRock believes that it is critical that the CFTC work closely with the DOL as it develops its Proposed Fiduciary Definition to ensure that compliance with the Proposed Rule does not result in fiduciary status for SDs under ERISA. The following provisions of the Proposed Rule illustrate some examples of actions SDs would be required to take under the Proposed Rule which may trigger ERISA fiduciary status:

Scenario Analysis. Section 23.431(a) of the Proposed Rule requires a SD to disclose information regarding the material risks, characteristics, material incentives and conflicts of interest regarding a swap. Among other things, the Proposed Rule requires SDs to provide scenario analyses when they offer to enter into high-risk complex bilateral swaps.

Daily Mark. Section 23.431 of the Proposed Rule specifies the circumstances under which a SD would be required to provide a daily mark to its counterparty. The Proposed Fiduciary Definition provides that an "appraisal" concerning the value of securities or other property provided to a Plan may be considered "advice."[12]

Suitability Requirement. The Proposed Rule also includes a suitability requirement that requires the SD to make a determination that any swap or trading strategy involving swaps recommended to a counterparty is suitable for the counterparty based on information obtained through a reasonable due diligence process.

V. *Increased Disclosures are Burdensome and Disproportionate to the Benefits.*

The Proposed Rule imposes significant additional disclosure obligations on SDs and MSPs. Specifically, before a SD or MSP could enter into a swap with a counterparty, the SD or MSP would be required to disclose material information about the risks,

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[11] 29 C.F.R. 2510.3-21, et. seq.

[12] *See* 75 Fed. Reg. at 65277.

characteristics, incentives and conflicts of interest regarding the swap.[13] We believe this increased disclosure will likely increase the costs to the counterparties of entering into these transactions without any corresponding benefit.

For most clients, BlackRock makes the decision to enter into a swap transaction on the client's behalf. BlackRock conducts its own investigation to determine whether the swap is appropriate to the client's risk management or investment objectives. Requiring the SD to provide information about a swap to a counterparty prior to entering into the swap would serve no purpose because the client relies on BlackRock, through the grant of investment discretion, to diligence and recommend the swap. In fact, requiring such disclosure would actually hurt BlackRock clients by increasing the time necessary to enter into a swap. By the time the SD makes the required disclosure to the client, the swap may no longer meet the client's needs.

The CFTC's suggestion that standardized disclosure may suffice for some types of swaps further strengthens the case against requiring pre-swap disclosure. The CFTC concedes that such disclosure may be appropriate if it would apply to multiple swaps of a particular type and asset class. A party can realize any benefit from standardized disclosures by reviewing such disclosures once, perhaps at the beginning of a trading relationship. Therefore, at a minimum the CFTC should permit such standardized disclosures to be made to a counterparty on a relationship basis rather than on a transaction-by-transaction basis. Further, if the counterparty wishes to enter into a swap for which it has previously received a standardized disclosure, its SD should not be required to provide such disclosure again before entering into the swap.

VI. *The CFTC Should Clarify the Definition of Special Entity.*

The Proposed Rule does not further define the term "employee benefit plan" as set out in CEA Section 4s(h)(2)(c)(iii). Instead, the CFTC requests comment on the scope of this term.[14]

BlackRock urges the CFTC to confirm that a collective investment vehicle or pooled fund in which an ERISA plan invests is not itself a Special Entity under CEA Section 4s(h)(2)(c)(iii) when the vehicle or fund enters into a swap with a SD counterparty. These vehicles or funds may contain investment assets of ERISA plans. However, nothing in the Special Entity statutory provisions suggests that Congress intended those vehicles or funds to be Special Entities. Instead, the Special Entity provisions focus on instances where ERISA plans are the swap counterparty. The CFTC should not attempt to expand the statute's reach beyond its literal language to extend the Special Entity provisions to swaps entered into by these collective investment vehicles or pooled funds.

However, the definition of "Special Entity" should encompass master trusts holding the assets of one or more Plans funded by a single employer. Many employers combine their pension plans into a single trust. In our experience, when entering into swaps on behalf of Plans, BlackRock often enters into them on behalf of all of the Plans of a single employer in a master trust. Clarifying that a Special Entity includes master trusts is, thus, consistent with market practice.

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13 This requirement would only apply if the counterparty is not a SD, MSP, security-based SD or major security-based swap participant.

14 If the CFTC determines to expand the entities that are "employee benefit plans" as suggested by some of its questions, we believe that it should seek further public comment on a specific proposal. While posing questions may meet the technical requirements for APA compliance, a determination of Special Entity status is of such importance to SDs, MSPs and Special Entities alike that it should not be announced only in a final rule.

VII. *The CFTC Should Adopt Swap Execution Standards Based on its Actual Experience with DCMs and SEFs.*

BlackRock is very familiar with and supportive of complying with flexible best execution standards for its clients. In serving our clients' interests, we seek to negotiate swaps and place orders that serve our clients' best interest. We therefore agree with the CFTC's purpose underlying the proposed new rule 155.7.

Nevertheless, we request that the CFTC not adopt the Proposed Rule at this time. It is premature to consider execution standards before the CFTC and the trading industry have had experience with swap trading on DCMs and SEFs. Setting rules in the absence of such experience seems to be a recipe for adverse unintended consequences. That is especially true given the mechanics contemplated by proposed rule 155.7.

As written, it is unclear whether a registered Commodity Trading Advisor or Futures Commission Merchant would need to provide on a per swap order basis the mandated disclosures to the customer. It is also unclear whether the required disclosure, which must precede the actual order execution itself, could delay order execution which would be contrary to the interests of the customer. Last, like the CFTC, commenters could only evaluate the workability of a "best terms available" standard after real-world experience with swap execution platforms. We therefore urge the CFTC to repropose rules in this area after the CFTC and the markets have sufficient experience with request for quote and other execution platforms to be able to establish standards that we are confident will serve well the interests of customers.

Conclusion

We believe that the Proposed Rule represents an important step in providing safeguards for the financial markets. However, by proposing a regulatory regime that far exceeds the Dodd-Frank Act's requirements, the CFTC risks causing various unintended consequences.

As set forth above, the Proposed Rule's standard for independence may create confusion with other established tests of independence. If adopted, this rule would increase unnecessarily the administrative burden of complying with CFTC regulation. We are also concerned that, as drafted, the Proposed Rule could preclude Plans from participating in swaps. This result should be avoided because Congress intended that the Dodd-Frank Act would not harm Plans and their participants and beneficiaries. If Plans are unable to enter into swaps to hedge their risks, their ability to generate targeted investment returns and to ensure that assets will be sufficient to pay benefits may be impaired. In addition, we believe that the proposed disclosure requirements are burdensome and disproportionate to any benefits that may be realized from their imposition. A final potential consequence of the Proposed Rule relates to the feasibility of the swap execution standards in proposed rule 155.7. The CFTC should adopt rules in this area once it has sufficient data about transactions on swap trading platforms. Otherwise, the Proposed Rule may not mesh with and reflect the reality of the new trading platforms.

BlackRock welcomes the opportunity to further discuss its views on this important topic with the CFTC staff.

Sincerely,

Joanne Medero