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SUGGESTED MODIFICATIONS OF THE CFTC'S PROPOSED BUSINESS CONDUCT STANDARDS

Many swap-related rules proposed in the past several months by the Commodity Futures Trading Commission ("CFTC") and/or the Securities and Exchange Commission ("SEC") would have very serious adverse effects on retirement plans and other plans governed by the Employee Retirement Income Security Act of 1974 ("ERISA"). The most problematic of these proposed rules are the business conduct standards proposed by the CFTC. This document briefly (1) explains why the use of swaps are so important to pension plans, (2) describes the key problems with the proposed business conduct standards, and (3) provides regulatory language for two specific means of solving those problems.

Importance of Swaps to Pension Plans.

Pension plans use swaps to manage interest rate risks and other investment risks, and to reduce volatility with respect to funding obligations. If swaps were to become materially less available to plans, plan costs and funding volatility would rise sharply. This would undermine participants' retirement security and would force employers to reserve, in the aggregate, billions of additional dollars to address increased funding volatility. These reserves would have to be diverted from investments that create and retain jobs and that spur economic growth and recovery.

Concerns with the Proposed Business Conduct Standards.

Conflict with proposed DOL regulations. The proposed business conduct standards would require swap dealers and major swap participants ("MSPs") that enter into swaps with retirement plans and other plans governed by ERISA to provide certain services to those plans, including providing information regarding the risks of entering into a swap. The required services would likely make the swap dealer or MSP a plan fiduciary under a regulatory definition recently proposed by the Department of Labor ("DOL") (and possibly under the current-law definition). For example, when a swap dealer or MSP is a swap counterparty to an ERISA plan, the proposed CFTC business conduct standards would require the swap dealer or MSP (1) to provide the plan with information about the risks of a swap, (2) to provide swap valuation services to the plan, and (3) to review the plan's advisor. Each of these required acts would likely make the swap dealer or MSP a plan fiduciary under the DOL's proposed regulations.

As further explained below, if a swap dealer or MSP provides a plan with certain types of information, the swap dealer or MSP will be deemed to be an "advisor" and required to "act in the best interests" of the plan. The proposed business conduct standards actually *require* swap dealers or MSPs to provide such information to plans, thus triggering the best interests standard in all cases. Advisors acting in the best interests of a plan are fiduciaries under ERISA.

If a swap dealer or MSP is a plan fiduciary, it would be a prohibited transaction under ERISA for the swap dealer or MSP to enter into a swap with the plan. Thus, the proposed business conduct standards would require a swap dealer or MSP entering into a swap with an

ERISA plan to violate ERISA. The only way to avoid this result is for all swaps with plans to cease, which would be devastating for plans, as discussed above.

This is not solely a DOL issue. The CFTC needs to coordinate with the DOL on this issue to prevent the very harmful and unintended result described above. We recognize that the President's recent Executive Order does not technically apply to the CFTC, but the point expressed there—the importance of regulatory coordination—is clearly sound.

The interaction of the business conduct standards and the DOL's definition of a fiduciary needs to be publicly and formally resolved by the time the CFTC finalizes the business conduct standards. If the issue is not resolved before finalization of the business conduct standards, there would be an immediate chilling effect on all swap risk management by plans due to uncertainty regarding current and future DOL regulations.

Meaning of advisor. Under Dodd-Frank, if a swap dealer or MSP acts as an "advisor" to a plan, the business conduct standards shall apply certain requirements to the swap dealer or MSP, including a duty to act in the best interests of the plan. Under the CFTC's proposed business conduct standards, if a swap dealer or MSP makes a "recommendation" to a plan, the swap dealer or MSP becomes an "advisor". The proposed business conduct standards then define "recommendation" so broadly that many standard communications used by a swap dealer or an MSP in the selling process—such as "this swap may fit your interest rate hedging needs"—would be a "recommendation" and thus turn a swap dealer or MSP into an advisor. In fact, the term "recommendation" is defined so broadly that it would include information regarding plan risks that the proposed business conduct standards require a swap dealer or MSP to provide to a plan.

This means that swap dealers or MSPs acting solely as counterparties would be required to also act in the best interests of the plan. This is not possible (and, as noted above, would be prohibited by ERISA). A swap dealer or MSP as a party to a swap transaction cannot have a conflicting duty to act against its own interests and in the best interests of its counterparty with respect to the swap.

If a swap dealer or MSP clearly communicates to a plan in writing that it is functioning solely as the plan's counterparty, no communication by the swap dealer or MSP should be treated as a "recommendation".

Counterparty standard. If a swap dealer or MSP is simply acting as a counterparty with respect to a swap with a plan, the proposed business conduct standards require the swap dealer or MSP to carefully review the qualifications of the advisor advising the plan with respect to the swap, and to veto the advisor if appropriate.

This rule is problematic for several reasons. First, there is no basis for this rule in the statute; under the statute, a swap dealer or MSP's duties are fulfilled with respect to a swap with an ERISA plan if the swap dealer or MSP determines that the entity advising the plan is an ERISA fiduciary. Second, the Congressional intent underlying the business conduct standards was to protect certain entities, such as plans. But if swap dealers or MSPs can veto plan

advisors, plan advisors could potentially be reluctant to negotiate in a zealous manner against a dealer, thus severely hurting plans. Third, swap transactions often need to be executed quickly to effectively hedge plan risks; there is no time for investigations of advisors. Finally, reviewing a plan's advisor may well make a swap dealer or MSP a fiduciary of the plan, which, as discussed above, would in turn make the swap a prohibited transaction.

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Modifications of the Proposed Business Conduct Standards.

There are two alternative means to address the above concerns with respect to the proposed business conduct standards: Proposal #1 below (which is clearly preferred) and Proposal #2.

Proposal #1. The CFTC was authorized to issue business conduct standards under Dodd-Frank. Such standards were intended to protect counterparties dealing with swap dealers and MSPs. Such protection is unnecessary with respect to plans subject to ERISA. By law, such plans must be advised by a fiduciary that satisfies a prudent expert standard. Thus, ERISA plans have no need for counsel from their counterparty. In fact, as discussed above, such counsel is affirmatively harmful to ERISA plans. In that regard, in addition to the three problems noted above, there are numerous other aspects of the proposed business conduct standards that are harmful to plans.

Accordingly, the simplest, clearest solution is for the CFTC not to exercise its authority under Dodd-Frank to apply the business conduct standards to ERISA plans. This could be achieved very simply as follows.

Section 23.402 of the CFTC's proposed business conduct standards would be amended to add at the end thereof the following new subsection:

> (i) **ERISA plans.** No requirement of this subpart shall apply to a swap in which the Special Entity counterparty is a plan subject to the Employee Retirement Income Security Act of 1974.

Also, clause (vii) of section 23.450(b) would be deleted since it refers to ERISA plans.

Proposal #2. Proposal #1 solves a host of problems very simply. If Proposal #1 is not used, we would ask that the top three business conduct standard problems be addressed in the manner described below.

(a) **Conflict with proposed DOL regulations.** The preamble to the final business conduct standards needs to include the following statement:

> The Department of Labor has informed the Commission that, in the case of a swap with a plan subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), no action of a swap dealer or major swap participant that is required solely by reason of these regulations will make such swap dealer or

major swap participant a fiduciary under ERISA with respect to such plan. The Department of Labor has further informed the Commission that the Department will, within 90 days of publication of this regulation, make this clear in regulations, rules, or similar guidance, effective as of the effective date of the Commission's regulations.

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(b) **Meaning of advisor.** As noted above, the proposed regulations interpreted "advisor" so broadly that all swap dealers or MSPs would actually be required to be advisors. This needs to be fixed.

To fix this, the second sentence of section 23.440(a) of the proposed regulations would be revised to read as follows:

The term ["acts as an advisor to a Special Entity"] shall not include where a swap dealer:

(1) provides information to a Special Entity that is general transaction, financial, or market information,

(2) provides swap terms in response to a competitive bid request from the Special Entity, or

(3) discloses in writing on an annual basis to the Special Entity that the swap dealer is acting as an actual or potential counterparty with respect to the Special Entity and that any information or services provided by the swap dealer is not provided by the swap dealer as an advisor to the Special Entity. [New language]

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(c) **Counterparty standard.** The "lead" fiduciary (or its delegate) with respect to an ERISA plan is required by law to prudently select a fiduciary with expertise in swaps to advise the plan with respect to swaps. There is no need for the plan's counterparty to review that choice; in fact, as noted above, such a review would be severely counterproductive. Accordingly, the following amendments to the proposed business conduct standards should be adopted.

Proposed Rule 23.450 would be revised and supplemented to read as follows:

(a) Definitions.

(1) The term "statutory disqualification" means grounds for refusal to register or to revoke, condition, or restrict the registration of any registrant or applicant for registration as set forth in Sections 8a(2) and 8a(3) of the Act.

(2) The term "ERISA" means the Employee Retirement Income Security Act of 1974[1].

(b) **Applicable standards.** **[Unchanged in substance]** Any swap dealer or major swap participant that offers to or enters into a swap with a Special Entity shall have a reasonable basis to believe that the Special Entity has a representative that:

(1) Has sufficient knowledge to evaluate the transaction and risks;

(2) Is not subject to a statutory disqualification;

(3) Is independent of the swap dealer or major swap participant;

(4) Undertakes a duty to act in the best interests of the Special Entity it represents;

(5) Makes appropriate and timely disclosures to the Special Entity;

(6) Evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap;

(7) In the case of employee benefit plans subject to ERISA, is a fiduciary as defined in section 3 of ERISA; and

(8) In the case of a municipal entity as defined in § 23.451, is subject to restrictions on certain political contributions imposed by the Commission, the Securities and Exchange Commission or a self-regulatory organization subject to the jurisdiction of the Commission or the Securities and Exchange Commission, provided that, this paragraph shall not apply if the representative is an employee of the Special Entity.

(c) **Reasonable reliance on representations of the Special Entity.** **[Rewritten]**

(1) A swap dealer or major swap participant shall be in compliance with paragraph (b) of this section if it has received from a Special Entity or a Special Entity's representative a representation that the Special Entity or Special Entity's representative has a reasonable belief that the criteria in paragraph (b) of this section are or will be satisfied, provided that (i) any representation made at a prior time or in connection with a different swap must include an agreement to provide prompt notice of any change in the information covered by the representation, and no such notice has been

[1] Definitions related to the meaning of "independent" in paragraph (b)(3) have been deleted, since they are not relevant to ERISA plans. It is possible that they are helpful with respect to the other Special Entities, but we do not speak for such other Special Entities. Current paragraph (c) also relates to the definition of "independent" and has been similarly deleted.

given, and (ii) the swap dealer or major swap participant does not have actual knowledge that such representations are incorrect.

(2) Notwithstanding subparagraph (1), a swap dealer or major swap participant shall be in compliance with paragraph (a) of this section if it has received a representation from the Special Entity or the Special Entity's representative that the Special Entity is an employee benefit plan subject to ERISA and the plan's representative is a fiduciary as defined in section 3 of ERISA, provided that (i) any representation made at a prior time or in connection with a different swap must include an agreement to provide prompt notice of any change in the information covered by the representation, and no such notice has been given, and (ii) the swap dealer or major swap participant does not have actual knowledge that such representations are incorrect.

(d) **[*Unchanged in substance*]** Before the initiation of a swap, a swap dealer or major swap participant shall disclose to the Special Entity in writing:

(1) The capacity in which it is acting in connection with the swap; and

(2) If the swap dealer or major swap participant engages in business with the Special Entity in more than one capacity, the swap dealer or major swap participant shall disclose the material differences between such capacities in connection with the swap and any other financial transaction or service involving the Special Entity.

(e) **[*Unchanged in substance*]** This section shall not apply to a transaction that is

(1) Initiated on a designated contract market or swap execution facility; and

(2) One in which the swap dealer or major swap participant does not know the identify of the counterparty to the transaction.