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Sent: Monday, June 06, 2011 7:59 PM
To: Cela, Phyllis J.; Karpoff, Timothy
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Subject: FW: CFTC meeting regarding the business conduct standards

Thanks again for meeting with us last week. It was an excellent exchange of views. We and our companies, however, came away from the meeting very concerned about the upcoming business conduct standards and their effects on pension plans. In that regard, we wanted to be sure that you saw our e-mail summarizing our takeaways from the meeting, which we have shared with the Democratic and Republican staffs on the House Agriculture, Financial Services, Education and the Workforce, and Ways and Means Committees and on the Senate Agriculture, Banking, HELP, and Finance Committees.

We hope that we can continue our dialogue about the business conduct standards. We know that we all have the same objective, i.e., to avoid harm to pension plans and the retirees they serve. Thanks. Kent

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From: Kent A. Mason
Sent: Monday, June 06, 2011 3:59 PM
To:
Cc: ldudley@abcstaff.org; 'Diann Howland'
Subject: CFTC meeting regarding the business conduct standards

We met last Friday with the CFTC on the proposed business conduct standards and their effect on pension plans. Set forth below is a summary of that meeting. If you have any questions or if anything further would be helpful, please let us know. Thanks.

On Friday, June 3, the American Benefits Council, the Committee on Investment of Employee Benefit Assets, and seven large pension plan sponsors met with the CFTC regarding the proposed business conduct standards. This is the American Benefits Council's report on the meeting.

The CFTC officials were very generous with their time and there was an excellent exchange of ideas. *However, the Council came away from the meeting believing that unless the agencies' views change substantially, it appears likely that the final business conduct standards will cause very significant harm to plans.* The basis for this conclusion is provided below.

We discussed our three primary issues:

- (1) **Conflict with DOL regulations.** In our view, the proposed business conduct standards would require a swap dealer to perform three functions for plans that would make a swap dealer or major swap participant ("MSP") a plan fiduciary under the DOL's proposed fiduciary regulation: (a) the provision to the plan of information on the risks of a swap, (b) the provision of valuation services, and (c) the review of whether the plan's advisor is qualified to advise the plan with respect to the swap. Also, in our view, the third requirement would make swap dealers and MSPs fiduciaries under current law. As you know, if the swap dealer or MSP is a fiduciary, the swap would be a prohibited transaction.
- (2) **Advisor status triggering conflict of interest.** In our view, the proposed business conduct standards effectively require swap dealers to function as advisors to plans, thus triggering a duty to act in the best interests of the plan. This creates a conflict of interest that would, pending further clarification, prevent swap dealers from entering into swaps.
- (3) **Dealer's power to veto a plan's advisor.** As noted, the proposed business conduct standards require the swap dealer or MSP to review the qualifications of a plan's advisor. This would give the dealers and MSPs the right to veto plan advisors, which is very unhelpful. This would also hurt plans by making advisors less inclined to challenge dealers and MSPs for fear of being vetoed.

It was clear from the meeting that the CFTC is working hard on this regulation and devoting substantial time to it. They are trying to protect plans and at the same time be faithful to the statute. We are very appreciative of their efforts in that regard. However, as discussed in more detail below, we came away from the meeting very concerned that the effect of the regulations will likely be that pension plans will at best be significantly harmed, and at worst may well lose the ability to use swaps. This is attributable to three factors: (1) the CFTC feels constrained by the statute in certain respects that are very adverse to plans (we differ on the statutory interpretation issues), (2) the CFTC views the market differently than we do in terms of the likely effect of the regulations on that market, and (3) the CFTC and the DOL are working on different schedules and it is understandably very difficult to coordinate in a way that provides plans with all necessary guidance at the same time.

We make the above observations, not as a criticism of either agency, both of which are working hard to do the right thing, but simply as an expression of concern about the effect on pension plans and the retirees that rely on plans for retirement security. We very much appreciate your interest in the plan issues. We are letting you know about the deep level of our concerns in the hope that Congress, the CFTC, the DOL, and the private sector can work together in the next month to prevent what appears to be impending harm to plans.

CONFLICT WITH DOL REGULATIONS

The CFTC indicated that they understood our concern. However, they pointed out that what we want is comfort from the DOL that complying with the business conduct standards will not make a dealer or MSP a fiduciary; the CFTC stated that only the DOL can help in that regard. We noted that if the CFTC decides to finalize the business conduct standards before the DOL is ready to provide that guidance, almost all swaps with plans will likely cease. The CFTC responded by pointing out that Congress directed them to publish regulations according to a specific schedule (i.e., by mid-July).

This highlights one of the concerns noted above. When we met with the DOL, one of their points was that it was difficult for them to comment on the fiduciary rules when they are in the middle of reexamining those rules. (Our response was: the fundamental point that the fiduciary rules should not directly conflict with another agency's rules should be a straightforward issue that is not difficult to clarify even before the regulation is complete.) So if the DOL stays with that position, and the CFTC follows the statutory schedule for finalizing the business conduct standards, swaps with plans could cease.

We discussed this concern. Some skepticism was expressed by the CFTC as to whether swaps would cease. The swap business with plans has enormous importance for plans and dealers. In that context, the CFTC found it hard to believe that this business would shut down based on the conflict with the DOL regulations, especially in light of the fact that the DOL has written a letter stating that there is no conflict.

The CFTC raises a good issue. It is certainly possible that swaps would continue in reliance on the DOL letter. However, the information that we have received to date from the plan sponsors and the dealers is that most swaps would likely cease. If swap dealers are plan fiduciaries, engaging in a swap with a plan triggers a prohibited transaction. In the case of the large swaps that pension plans engage in, the liabilities under the Internal Revenue Code and ERISA attributable to a prohibited transaction are staggering and, in fact, could threaten the viability of companies in some cases. That is an enormous chance to take when there is no legal authority to support the transaction. Moreover, if there is no further clarification of the issue, swap market participants would know that we had on many occasions asked the CFTC and the DOL to clarify the issue by having DOL authorize the CFTC to say in the preamble to the final business conduct standards that no action required by the business conduct standards would make a swap dealer or MSP an ERISA fiduciary, yet that was not done. That fact would certainly give anyone great pause.

ADVISOR STATUS TRIGGERING A CONFLICT OF INTEREST

Under the proposed business conduct standards, actions that the swap dealers are required to perform – such as providing information regarding the material risks of the swap – would convert all dealers into advisors and force them into an unworkable conflict of interest, thus ending swaps with plans. We never got to this point in the meeting, but we are hopeful that it will be addressed. The CFTC seemed to recognize that the proposed definition of an advisor was

too broad.

The CFTC objected to our proposed solution to the problem – under which a counterparty is not an advisor if the counterparty clearly discloses that it is only acting as a counterparty and not as an advisor. The CFTC felt strongly that dealers’ sales materials – e.g., regarding how much swaps can help plans – should be viewed as advice that triggers a duty of the swap dealer to act in the best interests of the plan. We stated that no ERISA plan we are aware of looks to its counterparty for advice. It would be both extremely foolish and a violation of ERISA for ERISA plans, with experienced and knowledgeable advisors as required by ERISA, to look to their counterparty for advice and to enter into a swap because their counterparty said that the swap was a good deal for the plan. As required by ERISA, our members clearly recognize sales material as just that: sales materials.

The CFTC responded that if the dealers' materials were all viewed as sales materials, the statutory provision would have no effect. Some materials provided by dealers must be treated as making them advisors in order to give effect to the statute. This is another instance where the CFTC seems to feel constrained by the statute. Our takeaway from the meeting is that the CFTC will revisit their definition of an advisor, but under its revised definition, some sales materials, proposals, and negotiations would constitute advice, thus requiring the dealer to have an unworkable conflict of interest. Obviously, dealers will need to cease all communications that turn them into advisors. At best, this would hurt plans by eliminating a valuable source of information for plans, whose advisors can review proposals submitted by different dealers. At worst, if the final regulation is not clear as to what type of negotiations turn dealers into advisors, the regulations could make dealers so afraid to communicate with plans regarding customized swaps that plans are forced into standardized swaps that do not fit their needs very well at all, and thus expose plans to far greater funding volatility.

This very harmful result would be the result of two views. First, unfortunately, we were not able to communicate effectively that ERISA plans do not look to the opposing party for advice and, in fact, doing so would violate ERISA. Second, the CFTC believes that to give effect to the statute, some sales practices need to be viewed as advice. In our view, the statutory provision is an anti-abuse provision, like the anti-fraud provisions in the business conduct rules: a dealer should not purport to be the advisor to a counterparty plan. If a dealer does hold itself out to a plan as an advisor, the dealer should be subject to an unworkable conflict of interest. But if a dealer makes it clear that it is not functioning as an advisor, it should not be treated as such.

DEALER'S POWER TO VETO A PLAN'S ADVISOR

We pointed out that the rule giving the dealer the power to veto a plan's advisor does not technically apply to plans. The CFTC disagreed with that reading of the statute, and said that the statute was ambiguous on this point. The CFTC also noted that it has broad discretion under the business conduct statute to impose appropriate rules, so even if the statute does not expressly require the dealer to review a plan's advisor, the CFTC has the power to impose such a rule.

We also noted that giving the dealer the power to veto a plan's advisor is very harmful to plans for the many reasons we have discussed. It was interesting that the CFTC did not respond to this

on a policy basis. Their response was that that was an issue for Congress. The statute clearly contemplates that the dealer would have to review the qualifications of the advisors to some counterparties; thus, Congress has expressed its view that that review is helpful, not harmful to the counterparties. The CFTC has no power to make a different policy judgment. Thus, the CFTC will have to retain the dealers' ability to veto plans' advisors.

This is an extremely disturbing result. Plan advisors who are vetoed are likely out of business, so there will be enormous pressure on advisors not to alienate dealers. That pressure will undermine the advisors' ability to negotiate zealously on behalf of plans.

At the end of the meeting, we had a constructive discussion about whether the dealers' review of a plan's advisor (1) could be performed once at the beginning of a relationship between the dealer and the plan, and (2) could be structured so that if the plan can make certain representations, the dealer would have to accept the plan's advisor. This left us with a little bit of hope on this third issue, but we just began the discussion when the meeting had to end. The regulation would need to be changed very significantly to get to this result, so we remain extremely concerned about this issue. This is especially true since the CFTC seems committed to the point that, in order to effectuate the statute, the dealer has to perform a meaningful review of the plan's advisor and has to have some right to veto that advisor.

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