From: Klem, Christopher A. <Christopher.Klem@ropesgray.com>
Sent: Thursday, September 2, 2010 11:41 AM
To: BusConductStandardsCP <BusConductStandardsCP@CFTC.gov>
Subject: Comments on Business Conduct Standards
Attach: Comments for CFTC on Dealer Conduct Rules.pdf

For ease of use, we are sending the following comments as email text and as a separate PDF document.

We appreciate this opportunity to submit thoughts in advance of formal rule proposals by the Commission under the Dodd-Frank Act (the "Act"). We commend the Commission for providing this opportunity.

The comments below all relate to Section 731(h) of the Act. They are threefold: (1) The de facto requirement that certain Special Entities have an "independent representative" in order to transact with dealers is to be narrowly construed so as to cover only the governmental entities enumerated in subclause (h)(5)(A)(i); (2) the Commission should take a flexible approach both to the identification of "independent representatives," allowing ample room for appropriate internal resources of a Special Entity to qualify for this role, and to the de facto operational requirements for such representative, particularly where the representative is an employee, internal management company or other internal resource; and (3) the Commission should seriously consider making all dealer conduct requirements contemplated by Section 731(h) broadly applicable to dealers' interactions with all counterparties, and not just Special Entities, except to the extent contemplated by subclauses (h)(4)(B) and (C).

1. First, we would like to take the opportunity to address some of the apparent confusion concerning the extent of the requirement of Section 731(h)(5)(A)(i) of the Act that a swap dealer or major swap participant (each, a "dealer") entering into a swap with a "Special Entity" reasonably believe that such entity has an "independent representative" satisfying specified criteria.

Under one reading of the provision, the dealer is only required to reach such conclusion where the "Special Entity" is a governmental entity or a supranational or multinational government entity. In this regard, the operative statutory language provides that the dealer "shall comply with any duty established by the Commission for a swap dealer or major swap participant, <u>with respect to a counterparty that is an eligible contract participant within the meaning of subclause (I) or (II) of clause (vii) of section 1a(18) of [the Commodity Exchange Act]</u> [emphasis supplied], that requires the [dealer] to have a reasonable basis to believe that the counterparty that is a Special Entity has an independent representative. . ." The referenced subclauses in the statutory definition of "eligible contract participant" refer to governmental entities and supranational and multinational government entities.

A different reading focuses on the statutory requirement that the dealer comply with "<u>any</u> duty" [emphasis supplied] that the Commission might establish under the authority of this statutory provision. Under this reading, the Commission would be authorized to establish a duty owed by swap dealers to the enumerated governmental entities and then extend that duty to dealers' transactions with the rest of the universe of "Special Entities," which would include other governmental entities, pension funds and endowments.

For reasons of basic statutory interpretation, it is clear that the first reading is the one intended by Congress, and not the second. Over-reliance on the word "any" proves too much. If it indeed were the case that Congress intended that a duty specified with respect to clearly and narrowly identified counterparties could be applied to other counterparties, then there would have been no need to include the specific reference to the governmental entities in the first place. Proper statutory construction requires that all words of the statute, particularly highly intentional words (the intention here being amply demonstrated by the specificity of the reference), be given effect. The second reading would allow the Commission to ignore part of the statute. The emphasis on "any" in the second reading, if applied to other cases of statutory interpretation, could easily lead to highly expansive -- and unintended -- results. "Any" has a much more natural meaning here, which is that the Commission is not strictly required by the legislation to impose a duty as to ascertaining the existence of an independent representative for the enumerated governmental agencies.

To be sure, the first reading itself leaves a dangling loose end in construing the statute. Subclause (VII) of Section 731(h)(5)(A)(i) states that, with respect a benefit plan under ERISA, the independent representative shall be a plan fiduciary, as defined in ERISA. If the first reading of Section 731(h)(5)(A)(i) is the correct one, then this subclause may itself be largely surplus (except in the case of enumerated governmental entities which are themselves ERISA plans, which appears to be a highly limited category including certain tribal plans and public plans with a significant number of private employees). However, the surplus is much more readily tolerated in this subclause for several reasons. First, the surplus associated with the second reading of the statute would be in the operative clause of the statutory provision and not simply in one of seven criteria for an "independent representative." Where the second reading would necessarily produce surplus in the operative clause, and the first reading would arguably produce surplus in the condition, the second reading must give way to the first reading. Second, a review of the legislative process leading to the Dodd-Frank Act provides a ready explanation for subclause (VII). The limitation in the operative clause to enumerated governmental entities only appeared late in the drafting of the bill. Subclause (VII) was itself almost undoubtedly inserted in some of the later drafts on the assumption that there would be no such limitation. The push to complete the legislation left subclause (VII) in place, in a perfectly harmless way. It is hard to conceive of a comparable explanation for why the very specific words of the limitation are not intended to have the meaning provided by the first reading.

2. We next turn to the operation of the de facto requirement that certain Special Entities have a qualifying independent representative. Regardless of which Special Entities are ultimately affected by the Commission's rulemaking, we urge the Commission to take a flexible approach as to how the independent representation is structured from the viewpoint of the Special Entity. That is, different Special Entities will likely obtain independent representation in different ways -- in some cases from third-party experts and in other cases from ample internal expertise held by employees, governing board members, advisory committee members or even separately organized internal investment or financial management companies. Special Entities able to adequately identify their internal expertise should not be required to engage third party "experts" at the extra expense of unnecessary fees (perhaps of a magnitude sufficient to discourage transacting in some cases) and time spent (particularly in portfolio management contexts where swift execution is often of the essence). To take an obvious example, the International Monetary Fund in all likelihood is a multinational governmental entity of the type enumerated in Section 731(h)(5)(A)(i). It seems inappropriate and inefficient (not to mention counter-productive to the functioning of markets) to necessarily put such an entity to the task of hiring a third-party expert in order to satisfy a dealer that it can transact.

Some of the commentators on Dodd-Frank have debated what the "independence" requirement for the representative is all about -- "independent" from whom? In the context of the statute, this is not a hard question. Subclause (III) of Section 731(h)(5)(A)(i) provides the answer: the independent representative is to be "independent of the swap dealer or major swap participant." This makes all the sense in the world. The obvious concern of the statute is dealers misleading or otherwise taking advantage of their counterparties. And, on the spectrum of independence for these purposes, employees and other internal personnel are in most cases assuredly more independent than third-party experts, who must of necessity in the end rely to some degree on the good graces of the dealers for their engagements. The successive scandals this decade questioning our financial world (involving dealers selling mutual funds, commercial insurance brokers, and even certain specialty brokers alleged to have engaged in bid-rigging with respect to municipal derivatives) have taught us what we should have known at the beginning -- that financial intermediaries of all sorts frequently start in a compromised position. It would be ironic and unfortunate for the independent representative requirement to mandate use of a new industry of third-party experts, in the context of a statute that is otherwise trying to root out mandatory reliance on third-party experts that has failed in the past (see the rating agency provisions of Dodd-Frank).

Just as we would urge the Commission to take a flexible approach to the identification of an independent representative, we would also urge the Commission to take a flexible approach to the application of any operational requirements that are de facto imposed upon the representative, particularly recordkeeping requirements relating to pricing. In the case of active portfolio management by sophisticated internal managers, the burdens of such de facto requirements can easily outweigh the benefits.

3. Finally, we would urge the Commission to make any conduct standards for dealers adopted under Section 731(h) (other than under the authority of Section 731(h)(4)(B) and (C)) broadly applicable to all transacting by dealers, and not targeted on their transacting with Special Entities. The reasons for doing this are obvious. First, within the universe of Special Entities, there is a broad range of uses of derivatives and a broad range of sophistication about derivatives. Indeed, the ranges are likely representative of the ranges to be found in the overall institutional marketplace. Thus, rules that are good for the Special Entities as a group are likely good for the market as a whole. As the Commission is well aware, the large derivative issues of the not-too-distant past happened to involve industrial concerns (e.g., Procter and Gamble and Metallgesellschaft), and not Special Entities. Second, a special rule for a special category of counterparty is likely to cast a negative and unintended shadow on the rules of transacting with other counterparties. Would the fact that a dealer definitively owes a

specified disclosure to a Special Entity necessarily mean that a different type of counterparty is not entitled to that disclosure in the context of a particular transaction under general principles of disclosure? Perhaps not, but there is no good way of drafting a rule to avoid the ambiguity on this question that is necessarily created by special rules. Third, special duties to particular counterparties, if viewed as onerous by the dealers, will have the effect of making those counterparties undesirable from the dealers' perspective, raising the cost of transacting to the counterparties and perhaps precluding them from transacting.

What is perhaps not quite so obvious is the authority of the Commission to fulfill the mandate of Dodd-Frank by adopting broadly applicable rules. In our discussion of the application of the independent representative requirement above, we pointed out the principle of statutory interpretation requiring effect to be given to all words of a statute. Here it could be argued that application of the same principle would mean that the Commission is required to come up with special conduct rules with respect to Special Entities under some or another subclause of Section 731(h), perhaps subclause (h)(5)(B). We respectfully submit, however, that, viewing Section 731(h) as a whole, that is neither the mandate nor intent of the Act. A careful subparagraph-by-subparagraph review of the provision reveals this.

Subparagraph (h)(1) involves a broad grant of authority to the Commission to adopt (i) business conduct standards specifically mandated by subsection (h)(3), and (ii) antifraud, supervision, compliance and other rules, in this latter case to be adopted in the discretion of the Commission. Both sets of rules would presumably be applicable to dealers' transactions with all counterparties (subject to the Commission's ability to say otherwise in the exercise of its rulemaking authority). Subparagraph (h)(2) says that (x) where a dealer acts as an advisor to a Special Entity, the requirements of subparagraph (4) must be met, and (y) where a dealer acts as counterparty to a Special Entity, the requirements of subparagraph (h)(5) must be complied with. In this regard, it is clear from subparagraph (h)(4) that its provisions relate exclusively to transactions between a dealer acting as advisor and a Special Entity, whereas the same is not so clear in the case of subclause (B) of subparagraph (h)(5) (as that subclause provides discretionary authority to the Commission to promulgate further standards and requirements "in the public interest" or "for the protection of investors"). Subclauses (B) and (C) of subparagraph (h)(4) for sure require special rules for when dealers interact as advisor with Special Entities, and our comments are not intended to address these rules. It is harder to say that subclause (h)(4)(A) is a "special rule" for dealings with Special Entities, insofar as it recites basic antifraud rules deeply rooted in both federal securities and commodities law. As to subparagraph (h)(5), we note that subclause (h)(5)(A) contains the independent representative requirement considered above, and, as noted, subclause (h)(5)(B) provides broad rulemaking authority, perhaps only as to dealings with Special Entities, or perhaps more broadly -- the resolution of this issue is not critical because the contemplated rulemaking is not mandatory. As if the accumulation of rulemaking authority in the preceding subparagraphs might be insufficient, subparagraph (h)(6) comes along to say to provide very broad authority (and mandate rulemaking) with respect to dealer conduct, with no limitation of that authority to dealings with Special Entities.

Stepping back from the intricacies, we note that there is required rulemaking with respect to general conduct standards under subparagraph (3) and abundant authority for the Commission otherwise to adopt whatever rules it sees fit without limiting them to dealings with Special Entities under subparagraph (h)(1) and subparagraph (h)(6), if not also subclause (h)(5)(B). There is no mandatory rulemaking limited to dealer transactions with Special Entities, except as contemplated by subparagraph (h)(4). At that, at the risk of making a presumptuous comment as to how the Commission should proceed, it seems clear that the Commission should use its abundant rulemaking authority to clarify that the provisions of subclause (h)(4)(A) are broadly applicable to all dealings of a dealer, at the risk of otherwise effecting a general repeal of generally applicable antifraud rules under the principle of "inclusio unius est exclusio alterius," a result that was clearly never intended by Congress. Thus, a careful parsing of the statute demonstrates that the Commission can proceed here with broadly applicable conduct rules, without any special provisions relating to Special Entities (except as contemplated by subclauses (h)(4)(B) and (C)), which is the right result from a rulemaking policy perspective.

We have provided a substantially similar comment to the SEC with respect to its rulemaking under Section 764(h) of Dodd-Frank. We understand that this rulemaking is to be coordinated with the Commission's rulemaking under Section 731(h).

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