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Via Email, rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1000
Attention: Elizabeth M. Murphy, Secretary

Re: Release No. 34-64766
File No. S7-25-11
Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants

Ladies and Gentlemen:

This letter is submitted on behalf of the Federal Regulation of Securities Committee and the Institutional Investors Committee (collectively, the "Committees") of the Business Law Section of the American Bar Association (the "ABA") in response to the rules (the "Proposed Rules") proposed by the Securities and Exchange Commission (the "Commission") in the above-captioned release (the "Proposing Release"). The Proposed Rules set forth business conduct standards for security-based swap dealers and major security-based swap participants pursuant to Section 15F(h) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which was added pursuant to Section 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or the "Act"). The comments expressed in this letter represent the views of the Committees only and have not been approved by the ABA's House of Delegates or Board of Governors and therefore do not represent the official position of the ABA. In addition, this letter does not represent the official position of the ABA Business Law Section.

The Commission's proposals represent a positive step in the implementation of Section 764 of the Act. In this letter, we recommend that the Commission's final rules (the "Rules"):

(i) Answer affirmatively the question raised in the Proposing Release[1] whether a qualified employee of a "Special Entity"[2] may serve as its "Independent Representative;"[3]

(ii) Eliminate the Independent Representative requirement for (A) non-profit organizations with over $1 billion of net assets, (B) employee benefit plans, as defined in Section 3 of the Employee Retirement Income Security Act of 1974 ("ERISA"), that are subject to ERISA regulation ("ERISA plans") and have more than a minimum amount of net assets, as determined by the Commission, and (C) private foundations that are regulated under the Internal Revenue Code of 1986 (the "Code"), the rules of the Internal Revenue Service (the "Service") and the rules regarding "jeopardizing investments" in Section 4944 of the Code and the regulations promulgated thereunder (the "Regulations") (each such foundation, a "Private Foundation"), and for which the Commission may also wish to apply a minimum net asset test as noted above for ERISA plans;

(iii) Recognize that an employee of the plan sponsor of an ERISA plan (or that sponsor's affiliate) who is a plan fiduciary under federal law will be deemed to be qualified to serve as the plan's Independent Representative if the plan meets the minimum net asset standards suggested above;

(iv) Confirm that the Rules will not affect the indemnification rights or insurance coverage of a qualified employee who serves as the Special Entity's Independent Representative; and

(v) Limit the definition of "Special Entity" to exclude investment funds and managers who are not themselves Special Entities but who manage assets for the benefit of Special Entities.

We also propose that the Commission consider excluding non-profit organizations with over $1 billion of net assets from the definition of "Special Entities." This suggestion is based

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[1] See Section II.D.5.b of the Proposing Release at p. 125.

[2] Section 15Fh-2(e) defines the term "Special entity." The term covers: (1) a Federal agency; (2) a State, State agency, city, county, municipality, or other political subdivision of a State; (3) any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002); (4) any governmental plan, as defined in section 3(32) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(32)); or (5) any endowment, including an endowment that is an organization described in section 501(c)(3) of the Internal Revenue Code of 1986.

[3] See, *e.g*., discussion accompanying footnote 218 in Section II.D.5.b of the Proposing Release ("The Dodd-Frank Act is silent concerning the question of independence from the special entity, and nothing in the legislative history suggests that the Commission should prelude the use of a qualified independent representative that is affiliated with a special entity"). The Proposing Release elsewhere suggests that the Commission views the correct answer as being yes. In Proposed Rule 15Fh-5(a)(7) the Commission recognized that an affiliate of a Special Entity may act as its Independent Representative: "(7) In the case of a special entity defined in §§240.15Fh-2(e)(2) or (4), is a person that is subject to rules of the Commission, the Commodity Futures Trading Commission or a self-regulatory organization subject to the jurisdiction of the Commission or the Commodity Futures Trading Commission prohibiting it from engaging in specified activities if certain political contributions have been made, *provided that this paragraph (7) shall not apply if the independent representative is an employee of the special entity*." (Emphasis added). See Proposing Release at page 243.

on the following factors: (a) there is no record that Congress meant to include the largest, professionally managed non-profit institutions within the scope of "endowments" subject to the Act; in this regard, we note that the term "endowment" is not defined in the Act nor is it a legal term of art;[4] (b) prior Congressional action, including the Philanthropy Protection Act of 1995, supports a reading by which the term is narrowly applied consistent with the purpose of the Special Entity rules to protect unsophisticated charities from unscrupulous security-based swap counterparties;[5] (c) the largest institutional investors do not require the Act's protection, and indeed their risk management strategies may be impaired by costs and delays that may result from the Special Entity rules; and (d) by potentially impairing the ability of the investment management teams of large institutional organizations to use security-based swaps in risk management strategies, the managers may fail to satisfy their fiduciary duty under the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"), a uniform law in place in at least 48 states, which requires managers to use security-based swaps and other derivatives if the managers, acting as fiduciaries, determine that these swaps or other derivatives are appropriate for risk management purposes.[6] In sum, rather than providing any needed protection to these sophisticated, professionally managed institutions, the extension of the Proposed Rules to such entities may result in potential delays, higher costs, and an impairment of the fiduciary duty of the managers of such entities to hedge risk through customary risk management strategies (including security-based swaps).

Similarly, we propose that ERISA plans and Private Foundations be excluded from the definition of "Special Entities." Many of the same arguments set forth above appear to us to be equally valid for sophisticated, professionally managed ERISA plans and Private Foundations that wish to employ modern risk management techniques. ERISA plans are currently highly regulated and their managers are subject to substantial fiduciary duties. Private Foundations are subject to a comprehensive federal compliance regime that could result in large penalties should they engage in inappropriate derivatives transactions. In our view, the Commission may wish to consider excluding from the scope of its rules ERISA plans and Private Foundations (in which case it may also wish to impose minimum net asset requirements). Excluding sophisticated ERISA plans and Private Foundations from the scope of the rule will provide the organizations the protections contemplated by Congress without unnecessarily limiting the ability of professional in-house investment management, who are likely to be skilled in the proper use of security-based swaps and other derivatives to achieve their institutions' investment objectives.

[4] The Proposing Release recognizes that "[t]he term 'endowment' is not defined in the Dodd-Frank Act, or in the securities laws generally." Section II.D.1, footnote 189, at p. 101.

[5] During a colloquy regarding the Independent Representative requirement, Senator Blanche Lincoln of Nebraska, one of the sponsors of the Act, noted how "pension plans, governmental investors, and charitable endowments were ***falling victim*** to swap dealers marketing swaps and security-based swaps that they knew or should have known to be ***inappropriate or unsuitable*** to their clients." *Congressional Record*, July 15, 2010, p. S5903 (emphasis added).

[6] UPMIFA is discussed in more detail in footnote 12 below.

I. Overview

A. “Special Entities,” “Independent Representatives,” and “Advisors”

As noted in the Proposing Release, Congress enacted Section 15F(h) of the Exchange Act to protect the following types of organizations from solicitations to engage in “inappropriate or unsuitable” trades from swap dealers and major swap participants, including security-based swap dealers and major security-based swap participants (collectively, “SBS Entities”)[7]:

- a Federal agency;
- a State, State agency, city, county, municipality, or other political subdivision of a State;
- any employee benefit plan as defined in Section 3 of ERISA;
- any governmental plan as defined in Section 3 of ERISA; or
- any endowment, including an endowment that is an organization described in Section 501(c)(3) of the Code.[8]

As proposed, SBS Entities would be subject to certain business conduct rules governing their security-based swap-related business activities, and to special additional requirements when dealing as counterparties to Special Entities. The two principal requirements are:

- An obligation to have a reasonable basis to believe that the Special Entity is represented by an “independent representative;” and
- A duty to act in the best interests of each Special Entity to whom the SBS Entity serves as “advisor” with regard to a proposed security-based swap transaction.

Under Section 15F(h)(5) of the Act, an SBS Entity must have a “reasonable basis” to believe that a Special Entity that is an eligible contract participant under Section 1a(18)(a)(I) or 1a(18)(a)(II) of the Commodity Exchange Act has an independent representative that:

(I) has sufficient knowledge to evaluate the transaction and risks;

(II) is not subject to a statutory disqualification;

(III) is independent of the security-based swap dealer or major security-based swap participant;

(IV) undertakes a duty to act in the best interests of the counterparty it represents;

(V) makes appropriate disclosures;

[7] See page 22 of the Proposing Release and footnote 43, quoting Senator Lincoln.
[8] 15F(h)(2)(C) of the Exchange Act.

(VI) will provide written representations to the special entity regarding fair pricing and the appropriateness of the transaction; and

(VII) in the case of employee benefit plans subject to the Employee Retirement Income Security [A]ct of 1974, is a fiduciary as defined in section 3 of that Act (29 U.S.C. 1002).

The "eligible contract participant" definition in Section 1a(18)(a)(I) and 1a(18)(a)(II) of the Commodity Exchange Act covers government entities and their instrumentalities, agencies, and departments, but no other "Special Entities." However, the Commission indicated in the Proposing Release that it intends to read the statutory language more broadly.[9] We suggest below what we believe are sensible interpretations of the requirement within the Commission's more expansive reading.

We note that the Commission's reading of the "eligible contract participant" definition represents a different approach from the Commission's interpretation of "advisor" status in the Proposing Release. In the case of its interpretation of "advisor," the Commission appropriately addressed the risk that certain unintentional consequences could arise from a strict application of Section 15F(h)(4) of the Exchange Act, relating to when an SBS Entity is deemed to be acting as an "advisor" to a Special Entity. We believe that the sensible public policy considerations underlying the Commission's approach to advisor status should apply with at least equal force to the elements of establishing qualified "independent representative" ("Independent Representative" or "IR") status under Section 15F(h)(5) and to the definition of "Special Entity" under Section 15F(h)(2)(C).

B. <u>Professionally Managed Non-Profit Investment Offices</u>

As the Commission recognized, the term "endowment" is not defined in the Dodd-Frank Act or in the securities laws.[10] The term also does not appear to have received any detailed consideration in the Congressional Record.[11] To the extent the term is mentioned at all, we found references to "charitable endowments," which likewise is not defined. It is unclear whether the term "charitable endowments" is intended to be identical to "endowments" or to be a subset of "endowments." However, the language suggests that charitable endowments are endowments in service of a charity, which are generally rather small, as contrasted with large, sophisticated institutional endowments that employ professional internal money managers. We believe this distinction is important because it distinguishes between those entities that need

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[9] See discussion at Section II.D.5.a of the Proposing Release.
[10] See footnote 4 above.
[11] The most detailed remarks we found in the Congressional Record on the term were Senator Lincoln's reference to "charitable endowments." See colloquy between Senators Lincoln and Harkin, "Independent Representatives," *Congressional Record*, July 15, 2010, p. S5903. As a key sponsor of Section 15F(h), Senator Lincoln's language is worthy of note. While neither "endowment" nor "charitable endowment" is a defined term, we believe that it is fair to interpret Senator Lincoln's usage of "charitable endowments" to demonstrate a focus on "charities," which in common usage suggests nonprofit organizations whose assets are not professionally managed internally. At the very least, Senator Lincoln's use of the term "charitable endowments" further suggests vague Congressional intent about what the term "endowments" should cover.

protection from unscrupulous SBS Entities and those that do not require such protection. In our view, Congress envisioned by creating the Special Entity and IR rules to protect the former, and not the latter, category.[12]

As fiduciaries under UPMIFA,[13] the officers of these institutional investors are explicitly required to manage risk of their institutions. Especially after the equity market losses in 2008 and the ascension of risk management as a core business function, the officers may be required to employ options, puts, calls, and other "security-based swaps" (as defined by the Act[14]) for hedging purposes and as part of their overall "toolkit." Indeed, during the market meltdown of 2008 the most successful investment offices of non-profit organizations were those that hedged equity risk through security-based derivatives.[15]

In our view, these large, sophisticated institutional investors share few characteristics with smaller charities except for their philanthropic purposes. Although their philanthropic purposes may bring them within the broad and vague scope of the term "endowments," large institutions generally have full time professional investment management teams experienced in a broad range of investment vehicles, whose investment determinations are subject to extensive oversight, analysis, and review.

In the absence of statutory guidance, we believe Congressional and Commission precedent are appropriate guides to a sensible application of the Act in order to distinguish those entities that require Special Entity status based on their need for the protections provided for in the Act from those that do not require the Act's protection. We are mindful of the Philanthropy

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[12] See footnote 5 above.

[13] The Uniform Prudent Management of Institutional Funds Act was approved by the Uniform Law Commission in 2007. (Uniform Prudent Management of Institutional Funds Act, 2007, avail. at http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006final_act.htm .) UPMIFA is law in 48 states, and is proposed as legislation in Mississippi (only Pennsylvania has not enacted or is considering the enactment of UPMIFA). (See http://uniformlaws.org/Act.aspx?title=Prudent%20Management%20of%20Institutional%20Funds%20Act .) UPMIFA imposes fiduciary duties upon persons who oversee "institutional funds," specifically funds held for charitable purposes, and effectively requires such funds to employ modern portfolio theory and allocation of risk principles. (UPMIFA, Section 2.) Under UPMIFA, each person responsible for managing a charitable endowment fund is subject to a duty of loyalty and is required to manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise in similar circumstances. In addition, each charitable endowment fund generally must diversify investments among any and all assets as it may determine and to rebalance the portfolio as needed, all as part of "an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution." (Id.)

[14] The Act includes puts, calls, and other options within the definitions of "swaps" and "security-based swaps," in addition to derivatives commonly considered as swaps. Commodities Exchange Act, Sections 1a(42), 1a(47). In this letter we use the term "security-based swaps" as defined in the Act.

[15] For example, Case Western Reserve University's 2008 returns, which beat the university's benchmark by 500 basis points, were credited to its "active risk management" hedging strategy positioned against the equity markets, which included shorts and options. F. Denmark, "University Endowments Build Better Risk Management Practices," *Institutional Investor*, April 21, 2011, at p. 36; Case Western Reserve University, "Pooled Endowment Funds 2008 Report," at http://case.edu/endowment/docs/2008investmentreport.pdf .

Protection Act of 1995 (the "PPA"),[16] in which Congress followed long-standing Commission precedent to enact a comprehensive set of exemptions from certain provisions of the federal securities laws applicable to charitable organizations, including the exemption of 501(c)(3) organizations from the definition of "investment advisers" under the Investment Advisers Act of 1940, as amended.[17] In this sense, traditional Congressional and Commission views of institutional nonprofit investors favor a reasoned definition of the term "endowments" under the Special Entity rules.

We would not advance these arguments if we believed that Special Entity status would be advantageous to these investors. However, as noted, it is our belief that Special Entity status could reduce the number of SBS Entities willing to trade in security-based swaps, and thereby raise costs through diminished competition and greater compliance burdens.. The burdens of IR evaluation, and the cost of ensuring IR qualification, for example, will raise an SBS Entity's compliance costs and could delay transactions or even take the SBS Entity out of dealing with a Special Entity if the IR approval process becomes adversarial and a threat to the greater business relationship between the parties. In addition, as discussed more in Section II.F below, we are concerned that with the discretion granted to SBS Entities under the Proposed Rules to approve or disapprove IRs based on subjective factors, there will be SBS Entities who will use this power improperly for unscrupulous purposes and thereby reinforce the ill treatment of Special Entities that the Act seeks to prohibit.

We recognize the difficulty of establishing objective criteria to measure the sophistication of institutional investors in all instances. However, the Commission has for years recognized that a test based on amounts of assets invested may provide an objective and reasonable basis for determining investor sophistication, such the definition of a Qualified Institutional Buyer ("QIB") pursuant to Rule 144A under the Securities Act of 1933, which requires that a QIB own and invest on a discretionary basis at least $100 million in securities of unaffiliated issuers.[18] Although the $100 million requirement for QIB status may be analogous to the level of sophistication contemplated here, we believe a $1 billion net assets test would be, at least initially, a more prudent measure to apply. Though many non-profit investment entities with less than $1 billion in net assets are sophisticated, professionally managed investors, the $1 billion net-asset level is broadly recognized within the industry as the level at which sophisticated professional management is standard. Moreover, anecdotally at least, institutional investors generally consider hiring chief investment officers and investment teams by the time their assets approach or reach $500 million. By setting the minimum net assets at $1 billion, we believe the exclusion would apply only to those entities that have an extremely high likelihood of having internal professional management teams.

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[16] Pub. Law 104-62 (Dec. 8, 1995), avail. at http://www.gpo.gov/fdsys/pkg/PLAW-104publ62/pdf/PLAW-104publ62.pdf.

[17] The history of this topic is well documented in the letter of the National Association of College and University Business Officers to the Commission dated August 29, 2011 entitled "Re: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants - Proposed Rule (File Number S7-25-11) (the 'Proposing Release')."

[18] Rule 144A(a)(1)(i) under the Securities Act of 1933, as amended.

We therefore propose that non-profit organizations with over $1 billion of net assets under management ("Institutional Investor Organizations" or "IIOs") not be required to use an IR. Further, we believe that such entities be excluded from the definition of Special Entities.

C. <u>Plan Fiduciaries as IRs</u>

We believe that the Commission's final rules should provide that a plan fiduciary of an ERISA plan that manages net assets above a specified minimum amount be deemed to be a qualified IR, absent statutory disqualification. We would defer to the Commission to determine the appropriate minimum net asset amount. As noted above, the Commission has ample experience evaluating and setting standards at which experience and sophistication should reasonably be presumed. We acknowledge that the minimum amount of net assets applicable to ERISA plans may be significant in light of the embedded liabilities of such plans to plan participants. However, we believe that industry guidance may be available as to when an ERISA plan is large enough to require sophisticated professional management (as is the case with non-profit institutions).

D. <u>Private Foundations</u>

Unlike other non-profit organizations, Private Foundations are subject to a particularly onerous set of excise tax rules that govern their operations. These are the so-called "jeopardizing investments" rules found in Section 4944 of the Code and the Regulations. The Code and Regulations impose fiduciary-like duties on Private Foundation directors and trustees (the "Foundation Managers") to safeguard the foundation's assets on behalf of the foundation's charitable constituency. The Regulations require that, when making an investment, Foundation Managers exercise "ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purpose."[19] Similar to UPMIFA, the Section 4944 regulations permit Foundation Managers to take into account "the expected return (including both income and appreciation of capital), the risks of rising and falling price levels and the need for diversification within the investment portfolio."[20] Under the Regulations, a number of types and methods of investment are subject to heightened Service scrutiny. These include: trading in securities on margin, trading in commodity futures, and the purchase of "puts", "calls" and "straddles,"[21] in other words, terms within the definition of "security-based swaps" under the Act.

Thus, Foundation Managers must be vigilant when investing on margin or in derivatives (<u>*i.e.*</u>, when investing in securities-based swaps) because of the enhanced Service scrutiny that

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[19] Treas. Reg. §53.4944-1(a)(2).

[20] In their seminal text on private foundations Bruce Hopkins and Jody Blazek state that Section 4944 generally parallels that of state law (<u>i.e.</u>, UPMIFA), where directors and trustees of foundations have a fiduciary responsibility to safeguard a charitable entity's assets on behalf of its constituents. B. Hopkins and J. Blazek, *Private Foundations: Tax Law and Compliance* (3d ed. 2008), at p. 295.

[21] Treas. Reg. §53.4944-1(a)(2)

applies to those investments. Indeed, failure to exercise the requisite standard of care and prudence in investing foundation assets can result in significant penalty taxes on both the Private Foundation participating in the investment and its Foundation Managers.

Because Private Foundations are by statute non-profit organizations that are not publicly supported, there is no evidence of Congressional intent to treat Private Foundations as "endowments" to which the IR rule applies. Moreover, for the same reasons noted above, the additional burdens and delays arising from satisfying the IR requirement could inhibit Private Foundation and the Foundation Managers from carrying out their duty to deploy security-based swaps as they determine necessary to hedge risk or otherwise as a means of safeguarding the foundation's assets.

On the basis of the foregoing, we propose that Private Foundations not be required to use an IR and that they be excluded from the definition of Special Entities for the reasons set out further below. Although Private Foundation status may itself be sufficient to qualify for this exclusion, we acknowledge that, in view of the Act's purpose, it may be desirable to set a minimum net asset threshold for Private Foundations.

II. <u>Construing the Qualified IR Requirement</u>

A. <u>Selection of an Employee of a Special Entity as its IR</u>

As the Commission has recognized, there is legislative history indicating that an IR's "independence" refers to independence from the dealer or broker, not the Special Entity.[22] In fact, the Congressional proponents of Section 15F recognized that Special Entities may use an in-house risk specialist as the IR, and the Commission seems to have made this assumption in Proposed Rule 15Fh-5(a)(7).[23]

This is a sensible conclusion. However, without express confirmation in the Rules, SBS Entities may doubt whether they can accept a qualified employee acting as their counterparty's IR, and their doubt may reduce liquidity, raise costs, or impose delays. Similarly, employees who are qualified to serve as an IR may desire assurance that their proper activities as an IR are not *ultra vires* as a matter of corporate law or (as discussed further in Section III below) perhaps not protected under the indemnification provisions of the corporate charter or the company's insurance policies.

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[22] Colloquy between Senators Lincoln and Harkin, "Independent Representatives," *Congressional Record*, July 15, 2010, p. S5903 (Senator Lincoln: "Our intention in imposing the independent representative requirement was to ensure there was always someone independent of the swap dealer or the security-based swap dealer reviewing and approving the swap or security-based swap transactions. However, we did not intend to require that the special entity hire an investment manager independent of the special entity. Is that your understanding, Senator Harkin?" Senator Harkin: "Yes. That is correct."). Please see footnote 3 above.

[23] Colloquy between Senators Lincoln and Harkin, "Independent Representatives," *Congressional Record*, July 15, 2010, p. S5903 (Senator Harkin: "We certainly understand that many special entities have internal managers that may meet the independent representative requirement.").

Therefore, for purposes of clarity, we ask the Commission to confirm in the Rules that an employee who satisfies the requirements of Section 15F(h)(5) of the Act may serve as the IR of a Special Entity.

B. <u>Exemption for Institutional Investor Organizations</u>

The Proposed Rules require SBS Entities to determine whether an IR is qualified as prescribed. As discussed further in Section II.F below, we believe that the subjective measurements of IR qualification give SBS Entities too much discretion to assess a designated IR. At the very least, the IR evaluation may cause delays in valid security-based swap transactions, and the rejection of an IR may cause further delays. Needless to say, delays often can frustrate the economic basis for hedging strategies.

For the reasons stated, we believe that there is no public policy objective achieved either by requiring an Institutional Investor Organization to have an IR, or, if one must be required, to permit SBS Entities to reject the IIO's selection of its IR. As discussed, these entities are managed by fiduciaries who are specifically charged under UPMIFA to manage risk. A routine function of many of them is risk analysis and the negotiation and execution of security-based swaps with SBS Entity counterparties who they evaluate and monitor for creditworthiness and compliance with collateral calls, marking to market, and other contractual obligations. Their familiarity with security-based swap execution and compliance demonstrates they do not need the protections of the Act at the cost that those protections may exact. Thus, in our view, IIOs, as risk managers holding over $1 billion of net assets, do not require an IR subject to the approval of their counterparties.

Further, in the interest of clarity, we would ask that the Rules likewise exempt any wholly owned subsidiary or other wholly owned affiliate of any IIO that satisfies the foregoing conditions. Limited liability companies and other "special purpose vehicles" are often used by institutional risk managers to "ring fence" the potential liability of these entities as derivatives trading parties. Use of these vehicles diminishes the risk of security-based swap transactions by capping financial exposure, and so we would suggest that they be addressed in the Rules.

Short of IIOs being exempted from the IR requirement, if the IR is an IIO employee who owes a fiduciary duty to the IIO, then we believe it is entirely appropriate for the Commission to preclude SBS Entities from applying clause (a)(1) of proposed Rule 15Fh-5 – which calls for the SBS Entity to decide whether the IR has sufficient knowledge to evaluate the transaction and risks – as the basis for a "special circumstances" determination. Nor should the SBS Entity be able to declare the existence of "special circumstances" arising under clauses (a)(3), (a)(4), and (a)(5) of the proposed Rule when the IR is an employee fiduciary. Indeed, as a fiduciary the Special Entity may not want the IR to provide evidence of these matters to the SBS Entity, and if the IR is also a lawyer then doing so may implicate the attorney-client privilege.

C. Exemption for Plan Fiduciaries as IRs

As addressed in note 178 of the Proposing Release, not all employee benefit plans that are Special Entities are ERISA plans. For this reason, different regulations may be appropriate for Special Entities that are ERISA plans and satisfy the minimum net asset standards stated above, as opposed to employee benefit plans that are subject to state law instead of ERISA.

ERISA imposes fiduciary duties upon the person that makes the decision to enter into a security-based swap on behalf of an ERISA plan. ERISA requires this person – in its capacity as a fiduciary of an employee benefit plan – to discharge its duties "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[24] Section 404(a)(1) of ERISA requires a fiduciary to "discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries [of the plan]." Moreover, ERISA prohibits a fiduciary from acting on behalf of an ERISA plan if the fiduciary has conflicted loyalties (which would be the case if the plan's fiduciary was not independent of the opposing party to a security-based swap).[25] Both the Department of Labor and the Service have administrative responsibilities for ERISA plans that include authority to enforce, and impose penalties on, violations. It is our belief that these criteria should qualify ERISA plan fiduciaries to serve as the IR for their respective plans if those plans satisfy the minimum net asset requirements suggested above.

D. Exemption for Foundation Managers as IRs

Because Private Foundations are by statute non-profit organizations that are not publicly supported, there is no evidence of Congressional intent to treat Private Foundations as "endowments" to which the IR rule applies. Moreover, as noted above, Private Foundations and Foundation Managers may only deploy security-based swaps with utmost care to avoid penalty. For these reasons, the additional burdens and delays arising from satisfying the IR requirement could inhibit Private Foundations and the Foundation Managers from carrying out their duty to deploy security-based swaps as they determine necessary to hedge risk or otherwise as a means of safeguarding the foundation's assets. As indicated, if the Commission believes it is a necessary additional threshold, this exemption may be limited only to Private Foundations that hold sufficient net assets in the amount the Commission may determine.

E. Further Clarifications of the Rules For Employees who are IRs

We have several comments on specific aspects of the IR requirements under the Proposed Rules as they pertain to employees who are appointed as IRs by their employers.

We suggest that the final version of proposed Rule 15Fh-2(c) clarify that clause (3)(ii) thereof does not apply to any IR who is employed by the Special Entity. The 10% gross

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[24] ERISA § 404(a)(1)(B).
[25] ERISA § 406(b).

revenues test set forth in clause (3)(ii) appears to be inappropriate in this situation. We would also suggest that the final Rule state that clause (3)(i) of the same proposal – prohibiting a person from serving as an IR if she worked for the SBS Entity within the past year – does not apply if the employee who is selected as the IR owes a fiduciary duty to the Special Entity. As a fiduciary to the Special Entity, the employee's prior employment by the SBS Entity should not be relevant – and, if it is, any actual breach of fiduciary duty should be governed by the Special Entity's legal duties under its charter and state law or other applicable legal requirements, not the Dodd-Frank Act. Moreover, unless modified, clause (3)(i) would require the Special Entity to hire a special IR only for trades with the relevant SBS Entity. The potential disruption, confusion, and cost arising from this outcome would be burdensome to Special Entities, and surely is not an intended consequence of the proposed Rule.

F. <u>SBS Entity Discretion in the Selection of an IR</u>

As noted, the purpose of the IR requirement is to protect each Special Entity covered by the statute by assuring that it has a qualified advisor who is "independent" of the SBS Entity. However, by giving the SBS Entity discretion to approve or disapprove the Special Entity's selection of its IR on subjective factors, we are concerned about whether proposed Rule 15Fh-5(a) could open the door to abuse of that discretion. Similarly, because proposed Rule 15Fh-2(a)(2) requires an SBS Entity to have a reasonable basis to believe that its Special Entity counterparty is advised by a qualified IR in order for the SBS Entity to avoid being treated as an advisor to the Special Entity, the SBS Entity could improperly exercise its discretion to exercise "veto power" over the Special Entity's selection of its IR.

This discretion could lead to improper outcomes by, for example, the threat of rejecting an IR selection in order to extract negotiating concessions on financial terms, or directing IR business to a third party IR at the expense of using inhouse expertise or cheaper third party alternatives. This abuse of discretion would not protect the Special Entity or further the goals of the Act.

We suggest curtailing the discretion on the part of SBS Entities by creating a presumption that the IR selection is acceptable if the SBS Entity receives representations from the Special Entity that the IR satisfies the relevant criteria in Exchange Act Section 15F(h)(5)(A)(i), and making that presumption voidable only if the SBS Entity possesses information that causes the SBS Entity to know that one of the IR representations is false. In that situation, knowledge of a false representation should be possessed by one or more senior representatives of the SBS Entity who themselves possess expertise in the subject area of the security-based swap transaction and who present their determination promptly in writing to the Chief Investment Officer and Chair of the Board, or equivalent person, of the Special Entity. Lower level employees should be required to pass along actual knowledge of false representations to these senior level employees. These conditions afford fair notice to the Special Entity, by which it may be able to convince the SBS Entity to reconsider, and reduces the risk that adverse determinations by SBS Entities would be made on improper grounds or by unqualified persons.

III. Indemnification of IRs employed by Special Entities

If an employee may serve as the IR, then it is reasonable to conclude that the employee's acts and omissions as the IR will be covered by the Special Entity's indemnification and insurance provisions to the same extent as the employee's other activities, assuming those activities satisfy the conditions required for indemnification or insurance coverage, as the case may be.

In the absence of Commission comment, there may be uncertainty regarding this question, and this uncertainty may discourage employees from serving as IRs. Because there may be significant benefits for employees to serve as IRs, it would be helpful if the Commission were to indicate in the adopting release that it does not view Section 15F as having any impact upon the indemnification rights or insurance coverage otherwise provided to employees of Special Entities who act as their IRs.

IV. Interpretation of Special Entity Definition

A. Institutional Investor Organizations

As noted, we do not believe that Congress considered how "Special Entity" status could be a burden, rather than a protection, to larger institutional investors. By reason of their professional in-house investment managers, such entities have the ability to evaluate security-based swaps and the role of SBS Entities, and to use security-based swaps as risk mitigation or risk management tools. In doing so, these tools assist those responsible for overseeing the institutional funds in fulfilling their statutory obligations and protecting the funds by hedging an overlarge risk, for example. Applying the Special Entity requirements on such entities could interfere with the managers' discharge of their legal duties. Without legislative history showing any careful consideration of the term "endowments," we recommend that the Commission adopt a sensible application of the term and exclude from the definition of Special Entities IIOs having $1 billion or more of net assets.

The express purpose of almost all endowments – and certainly the investment offices of $1 billion or larger organizations – is for long-term investment. Thus, unlike retirement funds or government plans, their occasional short-term losses may affect operations but would not hurt retirees or taxpayers. In other words, the impact, if any, is of a different order. Further, as discussed, the largest IIOs resemble other large, sophisticated institutional investors who are not subject to the Act, while, on the other hand, are very different from charities who may fall prey to unscrupulous SBS Entities and therefore require the protections created by the Special Entity rules. Thus, we believe it would be appropriate for the Commission to adopt a reasoned definition of the term "endowment" in this specific context, consistent with prior statutory provisions and traditional modes of nonprofit regulation.

Further, if IIOs are exempted, we would ask the Commission to exempt the wholly owned subsidiaries and other wholly owned affiliates of IIOs for the same reasons set forth in Section II.B above. As noted there, use of these entities only further mitigates and controls risk and therefore their use should not trigger the burdens of Special Entity status from which we recommend their related IIOs be exempt.

B. Private Foundations

As noted, Private Foundations are by statute non-profit organizations that are not publicly supported. Private Foundations are private pools of capital, which capital is distributed and expended for charitable purposes. Similar to IIOs, short-term losses suffered by a Private Foundation do not affect taxpayers and so would impact the foundation's founders and managers, not the public.

Because investment in security-based swaps by a Private Foundation is already subject to additional scrutiny by the Service as a potential "jeopardizing investment," it is not necessary to add another layer of regulatory protection and oversight to prevent excessive risk-taking by Private Foundations and the Foundation Managers. Accordingly, given the absence of Congressional intent to the contrary, and consistent with traditional application of federal law to Private Foundations, we believe the Commission should adopt Rules that the terms "endowment" and "Special Entity" as used in Section 15F(h) of the Act excludes any Private Foundation, i.e., any non-profit entity exempt from taxation under Section 501(c)(3) of the Code that is also subject to the "jeopardizing investment" rules under Section 4944 of the Code and the Regulations. Short of an absolute exclusion, as indicated, if the Commission wishes to set a minimum net asset requirement for Private Foundations, we believe the requirement should reflect the already rigorous regulation imposed on Private Foundations in their use of security-based swaps and other derivatives.

C. Third Party Investment Managers should not be Special Entities

In the Proposing Release the Commission asked whether investment firms should be deemed to be Special Entities if one or more of their clients are a Special Entity.[26] We think the answer is clear. Special Entities almost always are passive investors in funds and other investment vehicles managed by these investment firms. Extending the law to cover these managers would simply serve no statutory or regulatory purpose, especially as the Congressional intent was specifically aimed at the entities expressly defined as falling within the definition. To do so would, in our view, significantly burden these firms when the public policy basis of Special Entity regulation simply does not exist – and because compliance would increase costs, such regulation will simply cut into the potential gains that the passive Special Entity investors would otherwise receive for the benefit of their tax-exempt purposes.

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The Committees appreciate the opportunity to comment on the Proposed Rule and respectfully requests that the Commission consider the comments and recommendations set forth

[26] Proposing Release, Section II.D.1 at pp. 102-103.

above. Members of the Committees are available to discuss these comments should the Commission or the Commission's staff so desire.

Sincerely,

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