MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

December 23, 2010

Via Electronic Mail: rule-comments@sec.gov

Ms. Elizabeth M. Murphy
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Notice of Proposed Rulemaking on the Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps; File No. S7-32-10

Dear Ms. Murphy:

Managed Funds Association ("MFA")[1] welcomes the opportunity to provide comments on the Securities and Exchange Commission's (the "Commission" or the "SEC") proposed Rule 9j-1 ("Rule 9j-1") under the Securities Exchange Act of 1934 (the "Exchange Act"), which is intended to prevent fraud, manipulation and deception in connection with the offer, purchase or sale of any security-based swap, the exercise of any right or performance of any obligation under a security-based swap or the avoidance of such exercise or performance pursuant to Section 763(g) of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

We commend the Commission for its continued efforts to improve the integrity and competitiveness of our securities and derivatives markets and, in turn, its efforts to promote efficient capital formation, fair access to markets and timely dissemination of critical market data. Our comments below reflect our concern that the Commission's proposed rule could result in costly unintended consequences to the functioning and liquidity of the markets to which it would apply. The derivatives markets serve the crucial function of shifting risks and allowing market participants to effectively hedge their exposures. The uncertainty of the scope and the application of the Commission's rule would impair the ability of parties to enforce their security-based swap contracts and lower their willingness to trade, harming the depth of our markets.

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $1.5 trillion invested in absolute return strategies. MFA is headquartered in Washington, DC, with an office in New York.

I. Summary

The issues presented by Rule 9j-1 are of great concern to MFA and its members and we appreciate this opportunity to share our views. The following is a summary of our positions, which are explained more fully below.

1) MFA believes that the Commission has exceeded its authority under Section 763(g) of the Dodd-Frank Act and has gone beyond Congress's delegated authority in extending the prohibitions of Rule 10b-5 under the Exchange Act and Section 17(a) of the Securities Act of 1933 (the "Securities Act") to ongoing obligations between the execution and extinguishment of a security-based swap contract which do not fall within the statutory definitions of "purchase" and "sale."

2) We request that the Commission clarify that the statutory terms of "purchase" and "sale" will not include the post-execution performance of security-based swap contracts in accordance with their pre-negotiated terms.

3) We request confirmation from the Commission that the affirmative defenses under Rule 10b5-1(c) are applicable to security-based swaps.

4) We suggest that a scienter requirement should be imposed for all violations of Rule 9j-1 to prevent the proposed rule from sweeping too broadly and unintentionally prohibiting the legitimate performance of rights and obligations.

5) To avoid disruption, we request clarification that Rule 9j-1 applies prospectively to security-based swap contracts entered into after the effective date of Rule 9j-1.

We discuss each of these positions in more detail below.

II. The Commission Exceeds its Authority in Extending the Prohibitions of Rule 10b-5 and Section 17(a) of the Exchange Act to Transactions Between the Execution and Extinguishment of a Security-Based Swap.

MFA respectfully submits that the Commission is exceeding its Congressionally delegated authority in proposing that Rule 9j-1 extend the prohibitions of Rule 10b-5 under the Exchange Act and Section 17(a) of the Securities Act beyond purchases and sales to acts and omissions occurring during the term of a security-based swap. We submit that many events occurring after the execution and prior to the extinguishment of the security-based swap may not fall within the ambit of "purchases" or "sales" and should not be included within the Commission's proposed rule.

Section 763(g) of the Dodd-Frank Act provides that:

> it shall be unlawful for any person . . . to effect any transaction in, or to induce or attempt to induce the *purchase or sale* of, any security-based swap, in connection with which such person engaged in any fraudulent, deceptive or manipulative act or practice . . . .[2]

The Dodd-Frank Act amended the definition of "purchase or sale" in the Securities Act and in the Exchange Act to include, in the context of security-based swaps:

> execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishment of rights or obligations under, a security-based swap.[3]

In clarifying the terms "purchase" and "sale" in the security-based swap context, Congress chose specifically not to include ongoing obligations, which are dictated by the contract between the two parties underlying the security-based swap and which bear no relation to execution, termination, assignment, exchange and transfer or extinguishment of rights. Examples of such ongoing obligations include, but are not limited to, a variety of periodic or other types of payments under the terms of the security-based swap as well as many forms of collateral or margin payments, and related obligations. Such obligations and other requirements imposed under the parties' security-based swap contract exist during the life of a security-based swap.

To the extent the proposed rule includes "the exercise of any right or performance of any obligation under a security-based swap . . . .", Rule 9j-1 ignores this plain limitation on the Commission's delegated authority under Section 763(g) of the Dodd-Frank Act by appearing to extend the prohibitions of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act beyond just the execution, termination, assignment, exchange and transfer or extinguishment of rights.

In addition, we submit that the Commission errs in its proposing release by purporting to interpret Rule 9j-1 to extend beyond purchases and sales to include:

> [ongoing] payments or deliveries [that] occur after the purchase of a security-based swap but before the sale or termination of the security-based swap . . . .[4]

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[2] Wall Street Reform and Consumer Protection Act § 763(g), Pub. L. No. 111-203, 124 Stat. 1376, 1777 (codified 15 U.S.C. 78i(j)) (emphasis added).

[3] *See* Section 761(a)(3) and (a)(4) of the Dodd-Frank Act (amending Sections 3(a)(18) and (a)(14) of the Exchange Act). *See also* Section 768(a)(3) of the Dodd-Frank Act (amending Section 2(a)(18) of the Securities Act).

[4] Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, 75 Fed. Reg. 68560, 68561 (Nov. 8, 2010).

> the cash flows, payments, deliveries, and other ongoing obligations and rights . . . .[5]
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> [in the context of a total return swap] the total economic performance (*e.g.*, income from interest and fees, gains or losses from market movements, and credit losses) of a reference asset (*e.g.*, a debt security) (the "reference underlying"), in exchange for a specified or fixed or floating cash flow (including payments for any principal losses on the reference asset) . . . .[6]
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> activity in the reference entity underlying a security-based swap that triggers, avoids, or affects the value of ongoing payments or other delivery obligations under such security-based swap. . . .[7]

Congress's deliberate use of the words "purchase or sale" in Section 763(g) of the Dodd-Frank Act reaffirms the well-established principle in securities law that the Commission's antifraud authority is limited to the purchase or sale of securities. Section 763(g) places this limitation on the Commission's authority, much like the Congressional limits placed in Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act. Section 10(b), as amended, explicitly states that it applies only "in connection with the *purchase or sale* of any security . . . or any securities-based swap . . . ." (emphasis added).[8] Similarly, Section 17(a) applies only in the "*offer or sale*" of any securities or any security-based swap agreement" (emphasis added).[9] Although courts have held that changes in the rights of a security holder can qualify as a "purchase" of a new security under Section 10(b), for there to be a purchase "there must be such significant change in the nature of the investment or in the investment risks as to amount to a new investment."[10]

Rights or obligations, following the execution of the security-based swap transaction and prior to the extinguishment of the security-based swap, are determined at the outset of the entry into the transaction and are memorialized in the negotiated contract underlying the security-based swap transaction. The performance of interim obligations such as periodic payments of interest or dividends do not alter the risks assumed, nor do they change the parties' obligations and, therefore, do not constitute "purchases" or "sales."

The Commission also should not interpret the phrase "to effect any transaction in" in Section 763(g) to expand its authority, as this has not been the traditional understanding of that statutory phrase. The language "to effect any transaction in" is commonly used in the

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5 *Id.* at 68561-62.

6 *Id.* at 68562.

7 *Id.* at 68564.

8 15 U.S.C. 78j.

9 15 U.S.C. 77q(a).

10 *Abrahamson* v. *Fleschner*, 568 F.2d 862, 868 (2d Cir. 1977), *cert. denied*, 436 U.S. 905, 913 (1978).

Exchange Act and has never been understood to apply to conduct occurring during the time of owning a security unless a new investment decision is made.[11] Interpretations of "effect[ing] a transaction" are all confined to some participation in the process leading to the purchase or sale of a security.[12]

Additionally, many interim obligations during the term of security-based swap post-execution are ministerial in nature and are currently governed definitively by the contract that the parties have negotiated prior to the conclusion of the trade. We submit that the Commission has never been involved – and should not be involved – in the exercise of such private contractual rights and obligations between two parties. Hence, we request clarification that the disclosure obligations of Rule 10b-5 do not apply in the performance of ongoing obligations during the life of a security-based swap. Applying the disclosure obligations imposed in the context of insider trading under Rule 10b-5 to the exercise of the terms of pre-negotiated contracts could hinder the ability of market participants to continue to honor the terms of their contracts by creating uncertainty as to their obligations post-execution.

Periodic payments are set forth in the contract (*e.g.*, an International Swaps and Derivatives Association ("ISDA") Master Agreement and a Credit Support Annex), which are negotiated by the parties prior to the execution of the trade and before becoming aware of any material nonpublic information. Since it is virtually impossible to predict when a party will come into possession of material nonpublic information that might prevent its performance on such payments, parties will be unable to accurately predict the cash flows from the security-based swap at the outset.

We further submit that Rule 9j-1 should not affect a party's dealings with a reference asset or entity underlying the security-based swap and a party should be able to continue to enforce the terms of its bilateral contract. A situation that causes concern is as follows: a party holds bonds of a company and purchases a credit default swap ("CDS") on the company to hedge its risk; a bondholder may be approached by an issuer and become privy to the restructuring plans of the company and may engage in good faith negotiations or discussions with the company regarding the restructuring. The receipt of such material nonpublic information should not preclude the party from being able to perform its obligations or exercise its contractual rights under its CDS contract to pay or receive the agreed-upon payments to be made in accordance with the agreement. To include such dealings in Rule 9j-1 would reduce the willingness of bondholders to enter into necessary restructuring conversations with reference

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[11] The language "to effect any transaction in, or to induce or attempt to induce the purchase or sale of" appears in several places in the Securities Act and the Exchange Act. This language appears in the broker-dealer registration provision, Section 15(a)(1) of the Exchange Act, and also appears throughout Section 15(c) of the Exchange Act, which regulates broker-dealers. Variants on "effect a transaction" also appear throughout Section 9 of the Exchange Act. Generally, this language appears to be used interchangeably with "purchase or sale."

[12] *Massachusetts Financial Services, Inc.* v. *Securities Investor Protection Corp.*, 411 F. Supp. 411, 415 (D. Mass.) *aff'd*, 545 F.2d 754 (1st Cir. 1976), *cert. denied*, 431 U.S. 904 (1977). *See also U.S.* v. *Naftalin*, 441 U.S. 768 (1979) (broadly defining "in the offer or sale" in Section 17(a) of the Securities Act to encompass the entire selling process).

entities if they cannot enforce the terms of their CDS if such conversations were to fail. This serves only to impede orderly restructuring efforts.

Furthermore, Section 763(g) of the Dodd-Frank Act directs the Commission to "define, and prescribe means *reasonably designed* to prevent *such* transactions, acts, practices and courses of business as are fraudulent, deceptive or manipulative, and such quotations as are fictitious" (emphasis added).[13] The Supreme Court in *O'Hagan*[14] and *Schreiber*[15] has suggested that the Commission has latitude under the terms "means reasonably designed to prevent" to prescribe a "prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited . . . ."[16]

However, even this broader rulemaking authority must be rationally and reasonably tied to the statute and its purposes. In interpreting the same language (*i.e.*, "reasonably designed"), circuit courts have been consistent in requiring that the rules and regulations promulgated by the Commission pursuant to delegated authority from Congress retain a close nexus between the prohibited conduct and the statutory aims.[17] The Court of Appeals for the Second Circuit was clear that "the [Commission's] rulemaking power under [a] broad grant of authority is not unlimited."[18] The rule must still be "reasonably related to the purpose of the enabling legislation."[19]

The Commission's proposed rule purports to regulate interim obligations during the life of a security-based contract, which bear no relation to the execution, termination, assignment, exchange, transfer or extinguishment of rights. Congress unambiguously granted the Commission authority only with respect to purchases or sales.[20] When faced with a challenge to the Commission's authority in an enforcement action brought by the Commission, courts may be reluctant to enforce Rule 9j-1, thereby undermining rather than enhancing the Commission's enforcement authority.

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13 Dodd-Frank Act § 763(g).

14 *U.S.* v. *O'Hagan*, 521 U.S. 642 (1997).

15 *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985).

16 *U.S.* v. *O'Hagan*, 521 U.S. 642, 673 (1997).

17 *See SEC* v. *Maio*, 51 F.3d 623, 635 (7th Cir. 1995); *SEC* v. *S. Peters*, 978 F.2d 1162, 1166 (10th Cir. 1992); *U.S.* v. *Chestman*, 947 F.2d 551, 559 (2d Cir. 1991); *see also U.S.* v. *O'Hagan*, 521 U.S. 642 (1997) (citing *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1, 11 n.11 (1985)).

18 *U.S.* v. *Chestman*, 947 F.2d 55, 559 (2d Cir. 1991), quoting *Mourning* v. *Family Publications Service, Inc.*, 411 U.S. 356, 369 (1973).

19 *Id.*

20 *See* 5 U.S.C. § 706(2*)*; *Chevron U.S.A., Inc.* v. *Natural Resources Defense Council Inc.*, 467 U.S. 837, 842-44, 104 S. Ct. 2778 (1984) (administrative constructions which are contrary to clear congressional intent must be rejected); *see also U.S.* v. *Handy*, 570 F. Supp. 2d 437 (E.D.N.Y. 2008).

III. The Commission Should Construe the Terms "Purchase" and "Sale" Narrowly to Exclude the Post-Execution Performance of Security-Based Swap Contracts in Accordance With Their Terms.

We urge the Commission to exercise its discretion to (1) confirm that "extinguishment" of a security-based swap would not result from a party's exercise of its pre-negotiated contractual termination rights, or a party's performance of its pre-negotiated contractual obligations, under a security-based swap, and (2) exclude from Rule 9j-1 the exercise of pre-negotiated contractual termination rights under a security-based swap and the performance of pre-negotiated contractual duties under a security-based swap, so long as the entry into that security-based swap was not itself a violation of Rule 9j-1. We believe that the failure by the Commission to provide such a confirmation and exclusion would threaten the efficient operation of the security-based swap markets.

In a simple CDS, the CDS will refer to a "reference entity" who is not a party to the CDS. The CDS buyer typically makes periodic payments to the CDS seller. In exchange, the CDS seller would agree that, if a "credit event" were to occur, the CDS buyer could deliver a credit event notice, and the CDS seller would then either buy from the CDS buyer a debt obligation (e.g., a bond or a loan) of the reference entity at a pre-agreed price (physical settlement), or make a cash payment based on the excess of a pre-agreed price over the value of the reference entity's debt obligation determined in accordance with a specified procedure (cash settlement). Credit events are pre-negotiated.

We recognize that the physical settlement of a security-based swap may, under certain circumstances, constitute a "transfer" of the ownership of the underlying security and hence would be a "purchase" or a "sale" subject to Rule 9j-1. The cash settlement of a security-based swap, we submit, does not constitute such a "transfer." "Extinguishment" in the context of the "purchase" and "sale" definitions under the Exchange Act should be interpreted to refer to a destruction or cancellation of the relevant rights and obligations under a security-based swap. Delivery of a credit event notice or exercise of other pre-negotiated early termination rights under a CDS would not result in a "transfer" of rights or obligations thereunder. Rather, such an exercise would result in the performance – and therefore the satisfaction – of the terms of the CDS. We suggest that if the "purchase" and "sale" definitions were intended to reach simple performance, the statutory language would have been more explicit to that effect.

The terms of the Commission's rule referring specifically to an exercise of rights or performance of obligations is a grave concern. With respect to performance of obligations, we believe it would be inappropriate for the contractually obligated party to face a situation in which it must choose to either violate Rule 9j-1 or its contract. Performance of obligations is not a voluntary act that should be covered. With respect to exercise of rights that were created in a manner consistent with Rule 9j-1, it is exceedingly difficult, if not impossible, to be able to predict the likelihood of coming into possession of material nonpublic information during the life of a security-based swap. The price of a CDS is contingent on the ability of parties to receive agreed upon floating payments upon the occurrence of predetermined credit events. It is the basis on which parties are able to assume differing risk positions, and if parties are unable to rely

on the certainty of being able to receive such floating payments upon a credit event or terminate on the occurrence of pre-negotiated events, they would find it debilitating to determine whether to enter into a transaction. Such an interpretation by the Commission would risk grinding substantial CDS markets, as well as other security-based swap markets, to a complete halt.

To prevent severe disruption of the functioning of the derivatives markets, the Commission should define the terms of "purchase" and "sale" narrowly and exclude performance of security-based swap contracts, in accordance with agreed-upon terms, from the purview of Rule 9j-1.

IV. The Commission Should Confirm that Rule 10b5-1(c) Applies to Security-Based Swaps.

MFA urges the Commission to clarify that the affirmative defenses under Rule 10b5-1(c) are available in the context of a security-based swap.[21] Those defenses should be

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[21] SEC Rule 10b5-1(c) states that:

1. (i) a person's purchase or sale is not "on the basis of" material nonpublic information if the person making the purchase or sale demonstrates that:

A. Before becoming aware of the information, the person had:
1. Entered into a binding contract to purchase or sell the security,
2. Instructed another person to purchase or sell the security for the instructing person's account, or
3. Adopted a written plan for trading securities;

B. The contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section:
1. Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;
2. Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
3. Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and

C. The purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

2. A person other than a natural person also may demonstrate that a purchase or sale of securities is not "on the basis of" material nonpublic information if the person demonstrates that:

(i) The individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and

(ii) The person had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material nonpublic information, or those that prevent such individuals from becoming aware of such information.

incorporated into Rule 9j-1 to apply to purchases and sales of security-based swaps and, if the Commission does not agree with the authority concerns expressed above, to the exercise of any right or performance of any obligation under a security-based swap. Security-based swap agreements impose certain contractual obligations on the parties' post-execution performance of the swaps and the affirmative defenses under Rule 10b5-1(c) should be available in the exercise of the contract terms.

Under Rule 10b5-1(c), the Commission has established affirmative defenses that a person's purchase or sale is not "on the basis of material non-public information" if the person can establish that the person has no influence or discretion over the purchase or sale or the manner in which it takes place. The Commission has consistently opined that if a contract (such as a margin account contract) does not permit an insider to exercise any subsequent influence over how, when or whether to effect purchases or sales, an affirmative defense is available under Rule 10b5-1(c)(1) and (2).[22] The Commission determined that an affirmative defense is available under Rule 10b5-1(c)(1) and (2) in the exercise of an option, when in possession of material nonpublic information at the time of the exercise, when each of the amount, price and date of the transaction is *specified or determined by formula, or all subsequent discretion over purchases and sales are delegated to a third party* who is not aware of material nonpublic information when exercising that discretion.[23] Such a delegation must be made in good faith before becoming aware of material nonpublic information.[24] This principle should be equally applicable to security-based swap transactions where certain calculations are part of the performance of a swap contract or lead to the execution, termination, assignment, exchange and transfer or extinguishment of rights, and the parties to the contract do not retain any discretion or influence over such terms.

Hence, we urge the Commission to similarly confirm that these well-established principles in Rule 10b5-1(c) extend to performance in accordance with the terms of a security-based swap contract or transactions involving a "purchase" or a "sale" in a security-based swap if the rights and obligations of the parties are specified in the contract, and if the parties have not retained any discretion over its terms.

Additionally, MFA asks the Commission to clarify that good-faith modifications of an existing contract underlying the security-based swap, executed when the party is not aware of material nonpublic information, will not be prohibited by the proposed rule. This is consistent with the Commission's statement that "a person acting in good-faith may modify a prior contract, instruction, or plan before becoming aware of material nonpublic information."[25]

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22 *See* SEC, Exchange Act Rules Compliance & Disclosure Interpretations, Question 120.05-25 (Aug. 11, 2010).

23 *Ibid.* at Question 120.05 (Aug. 11, 2010).

24 *Id.*

25 *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7881 (Aug. 15, 2000); SEC, Exchange Act Rules Compliance & Disclosure Interpretations, Question 120.16 (Aug. 11, 2010).

Therefore, we submit that, consistent with the Commission's interpretations of Rule 10b5-1(c), the performance of negotiated and non-discretionary contractual terms and good faith modifications should be permitted under the proposed rule when performed in conformity with Rule 10b5-1(c)'s principles and the Commission's interpretations thereunder.

V. The Commission Should Make Clear that All Potential Violations of Rule 9j-1 Are Subject to a Scienter Requirement.

The Commission's proposed rule should make it an offense only if a market participant knowingly or intentionally engages in fraudulent and manipulative practices. We propose that the appropriate level of scienter should be specific intent or, at the minimum, extreme recklessness.

A specific intent standard is appropriate in light of the high penalties associated with a violation of the Commission's rules. The Commission should be persuaded that a market participant consciously sought to manipulate or defraud before imposing such substantial penalties. Congress, in granting the Commission authority in Section 763(g) of the Dodd-Frank Act, did not intend to regulate negligent practices or inadvertent mistakes but, rather, to punish and deter intentional or knowing manipulative and deceptive conduct. Additionally, imposing a negligence standard could give counterparties to a security-based swap grounds to withhold their performance of contractually agreed terms, *e.g.*, avoiding making a contractual payment on the theory that they do not want to be held to be inadvertently violating the Commission's proposed rule.

In the alternative, we urge the Commission to adopt an "extreme recklessness" standard. Rule 9j-1 should require "an extreme departure from the standards of ordinary care . . . to the extent that the danger [of misleading buyers or sellers] was either known to the defendant or so obvious that the defendant must have been aware of it," as the Seventh Circuit has held to be necessary for a violation of Rule 10b-5.[26] By adopting the extreme recklessness standard, the Commission will join almost all the circuit courts that have considered the level of scienter appropriate under antifraud rules in the securities context.[27]

Transactions in the derivatives markets involve sophisticated entities that can and do negotiate on an arm's-length basis to protect their own interests. Section 768 of the Dodd-Frank Act makes it unlawful for any person to offer to sell, offer to buy or purchase or sell a security-based swap to any person who is not an Eligible Contract Participant ("ECP") as defined

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[26] *SEC* v. *Lyttle*, 538 F.3d 601, 603, *quoting Makor Issues & Rights, Ltd.* v. *Tellabs Inc.*, 513 F.3d 702, 704 (7th Cir. 2008).

[27] *See id.*, *see also Phillips* v. *LCI Int'l, Inc*., 190 F.3d 609, 621 (4th Cir. 1999); *SEC* v. *Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992); *Hollinger* v. *Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc); *Ross* v. *Bank South, N.A.*, 885 F.2d 723, 730 n.10 (11th Cir. 1989); *Hackbert* v. *Holmes*, 675 F.2d 1114, 1118 (10th Cir. 1982); *Broad* v. *Rockwell*, 642 F.2d 929, 961 (5th Cir. 1981) (en banc); *McLean* v. *Alexander*, 599 F.2d 1190, 1197 (3d Cir. 1979); *Mansbach* v. *Prescott, Ball & Turben*, 598 F.2d 1017, 1025 (6th Cir. 1979); *see also Greebel* v. *FTP Software*, 194 F.3d 185, 198 (1st Cir. 1999); *Camp* v. *Dema*, 948 F.2d 455, 461 (8th Cir. 1991).

in the Commodity Exchange Act. ECPs, unlike retail investors who do not have the necessary resources, ability or bargaining power to negotiate terms of their contracts, do not need greater protection from the Commission.

We therefore urge the Commission to clarify that ordinary negligence or recklessness would be insufficient to establish a violation of Rule 9j-1. Congress sought to protect the integrity of competitive markets but not at the expense of discouraging legitimate competition. The imposition of significant civil penalties in a fraud investigation without any requirements of some form of willful conduct would impose liability for participants acting in good faith, a result that Congress did not intend. This would have myriad unintended adverse consequences. Market participants would likely reduce their participation in the derivatives markets for fear that their exercise of routine and administrative ongoing rights and obligations may be misconstrued by the regulators with the benefit of hindsight. Similarly, potential entrants may decide that regulatory risks outweigh potential benefits and not enter the market at all, significantly reducing the liquidity and depth of our markets.

VI. The Commission Should Clarify that Rule 9j-1 Applies Prospectively to Security-Based Swap Contracts Entered Into After the Effective Date of Rule 9j-1.

We submit that Rule 9j-1 should apply prospectively to security-based swap contracts entered into after the effective date of Rule 9j-1. Full compliance with the new anti-fraud obligations imposed by Rule 9j-1, across all security-based swap contracts, on a single effective date is, in our view, not feasible and could cause severe market disruption.

Security-based swap contracts entered into prior to the effective date of Rule 9j-1 were negotiated in a significantly different regulatory regime. Parties negotiated such security-based swap contracts based on a very different set of assumptions as to their ability to perform, as well as their ability to enforce their counterparties' performance of the pre-negotiated terms of their contracts. These security-based swaps were priced based on the parties' predictions of cash flows, collateral streams and credit events. The implementation of a new anti-fraud regime, particularly at the initial stages of implementation, would cast uncertainty on the parties' prior expectations which throw the risk profiles of such contracts into disarray. Changes in predictions of the ability to settle a security-based swap or to make calls for collateral would significantly change parties' perceptions of their previously agreed-upon price. This could prompt a rush by parties to unwind and terminate their security-based swap contracts prior to the effective date of Rule 9j-1 and paralyze the ability of market participants to properly hedge their risks (such as credit risk) if the markets were to shut down.

Market participants will also require some time to implement internal compliance policies and procedures for the negotiation and performance of their security-based swap contracts to comply with their expanded obligations. Applying Rule 9j-1 prospectively would grant market participants the time they need to revisit their policies and procedures governing the performance of their security-based swaps and to rectify the transition problems that would inevitably occur in the initial phases of the process. Hence we urge the Commission to

ameliorate the possible disruption to the functioning of the markets and clarify that Rule 9j-1 would apply prospectively.

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We appreciate the opportunity to provide our comments to the Commission regarding the proposed Rule 9j-1, and we would be pleased to meet with the Commission or its staff to discuss our comments. If the staff has questions or comments, please do not hesitate to call Jennifer Han or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell
Executive Vice President & Managing Director,
General Counsel

cc: The Hon. Mary Schapiro, SEC Chairman
The Hon. Kathleen L. Casey, SEC Commissioner
The Hon. Elisse B. Walter, SEC Commissioner
The Hon. Luis A. Aguilar, SEC Commissioner
The Hon. Troy A. Paredes, SEC Commissioner