ERIC
The
ERISA
Industry
Committee

February 22, 2011

Submitted through the Federal eRulemaking Portal:
http://www.regulations.gov

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Business Conduct Standards for Swap Dealers
<u>and Major Swap Participants (RIN 3038–AD25)</u>

Dear Mr. Stawick:

The ERISA Industry Committee ("ERIC") is pleased to submit these comments on the proposed business conduct standards for swap dealers and major swap participants dealing with Special Entities. The proposed rule was issued by the Commodity Futures Trading Commission (the "Commission") under the Dodd-Frank Act Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act").[1] The proposed rule was published in the *Federal Register* on December 22, 2010.[2]

ERIC is a nonprofit association committed to the advancement of the employee retirement, health, incentive, and welfare benefit plans of America's largest employers. ERIC's members provide comprehensive retirement, health, and other benefits to tens of millions of active and retired workers and their families.

Many of the employee benefit plans sponsored by ERIC's members use swaps as an important part of their asset management strategy. Swaps permit plans to hedge against market fluctuations, interest rate changes, and other factors that create volatility and uncertainty with respect to plan funding. Swaps also help plans rebalance their investment portfolios, diversify their investments, and gain exposure to particular asset classes without direct investment. By helping to protect plan assets as part of a prudent long-term investment strategy, swaps benefit the millions of participants who rely on these plans for retirement income, health care, and other important benefits. ERIC's members wish to ensure that the proposed rule does not inadvertently limit employee benefit plans' access to or use of swaps for these beneficial purposes.

---

[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 Fed. Reg. 80,638 (proposed Dec. 22, 2010) (to be codified at 17 C.F.R. pts. 23 & 155) (the "Notice").

1400 L Street, N.W.
Suite 350
Washington, DC 20005
T (202) 789-1400
F (202) 789-1120
www.eric.org

Summary

ERIC supports the Dodd-Frank Act's efforts to ensure that swap dealers and major swap participants deal fairly with Special Entities, including employee benefit plans. ERIC is concerned, however, that the proposed rule does not adequately reflect the complex statutory and regulatory requirements under which private-sector employee benefit plans already must operate. Employee benefit plans governed by the Employee Retirement Income Security Act ("ERISA") are represented in swap transactions by fiduciaries. These fiduciaries must meet standards of conduct described as "the highest known to the law." Many of the business conduct standards that apply to swap dealers and major swap participants duplicate protections already fully developed and strictly enforced under ERISA. Some of the requirements in the proposed rule create a risk that swap dealers and major swap participants will themselves be classified as fiduciaries under ERISA, a result that would be untenable and that the Dodd-Frank Act was designed to avoid.

Many of the business conduct standards confer no benefit on ERISA-governed plans. The greater danger, however, is that the standards will actually harm these plans by making swap transactions prohibitively expensive, or by discouraging swap dealers and major swap participants from dealing with ERISA-governed plans at all. This is not a hypothetical concern: some ERIC members have already been told by swap dealers that the dealers will cease to engage in swap transactions with ERISA-governed plans if the dealers are subject to the requirements set forth in the proposed rule. ERIC urges the Commission to modify the proposed rule as follows:

1. The Commission and the Department of Labor should coordinate their rules so that the business conduct standards will not require a swap dealer or major swap participant to undertake any duties or responsibilities that will cause it to be a fiduciary of an ERISA-governed plan.

2. The definition of "Special Entity" should apply to any trust that holds the assets of employee benefit plans sponsored by the same employer or related employers.

3. The Commission should recognize that the independent representative requirement is limited to governmental entities, and thus does not apply to ERISA-governed plans.

4. If the Commission continues to apply the independent representative requirement to ERISA-governed plans, the Commission should revise the qualification requirements for the independent representative of an ERISA-governed plan.

   a. The regulation should provide that the fiduciary of an ERISA-governed plan automatically satisfies the requirements for an independent representative.

   b. If the regulation does not exempt all ERISA fiduciaries from the independent representative requirements, the regulation should provide that a QPAM or INHAM acting for an ERISA-governed plan automatically satisfies the requirements for an independent representative.

5. The Commission should revise the rules for determining when a swap dealer is an "advisor" to an ERISA-governed plan.

   a. The regulation should provide that a swap dealer is never an advisor to an ERISA-governed plan.

   b. Alternatively, the regulation should permit the parties to agree in writing that a swap dealer is not an advisor to an ERISA-governed plan.

c. The regulation should explain what it means to "recommend" a swap transaction, and should make clear that a swap dealer does not "recommend" a swap transaction if the transaction is evaluated and approved by a fiduciary on behalf of the plan.

d. The regulation should make clear that no conduct other than recommending a swap transaction will cause a swap dealer to be classified as an advisor.

6. The regulation should permit the parties to agree in writing to modify the rules for providing a "daily mark" for uncleared swaps.

ERIC believes that the proposed rule correctly concludes that the "independent representative" of a Special Entity must be independent of the swap dealer or major swap participant, but need not be independent of the employee benefit plan, the plan sponsor, or its affiliates. ERIC urges the Commission to retain this interpretation when it issues the final rule.

Discussion

1. It is essential that the Commission and the Department of Labor coordinate their rules so that the business conduct standards to not require a swap dealer or major swap participant to become an ERISA fiduciary.

ERISA strictly prohibits the fiduciary of any ERISA Title I plan[3] from acting in a transaction in which the fiduciary has an interest adverse to the interest of the plan, or from dealing with the plan's assets for its own benefit.[4] Instead, a plan fiduciary must act solely in the interest of the plan participants.[5] As a result, it would be unlawful for a swap dealer or major swap participant simultaneously to act as a counterparty of an ERISA Title I plan and to act as a fiduciary of the plan: the two roles are fundamentally inconsistent. The principal sponsors of the Dodd-Frank Act recognized this conflict and worked closely with employee benefit plan sponsors to ensure that the business conduct standards would not require swap dealers and major swap participants to undertake fiduciary responsibilities toward ERISA Title I plans.[6]

The Department of Labor proposed a regulation last fall that would significantly expand the definition of "fiduciary" under Title I of ERISA.[7] Under the Labor Department's proposed regulation, a person is a fiduciary of an ERISA Title I plan if, among other things, the person provides advice to the plan concerning the value of property; makes recommendations to the plan as to the advisability of investing in property; or provides advice concerning the management of property, and the advice is individualized to the needs of the plan and may be considered in making investment

---

[3] As the Commission has recognized, not all employee benefit plans defined in section 3 of ERISA are subject to the strict fiduciary standards in Title I of ERISA. *See* Notice, 75 Fed. Reg. at 80,649 n.89. ERIC has used the term "ERISA Title I plans" throughout this comment to refer to employee benefit plans that are subject to ERISA's fiduciary standards.

[4] ERISA § 406(b), 29 U.S.C. § 1106(b).

[5] ERISA § 401(a)(1)(A), 29 U.S.C. § 1101(a)(1)(A).

[6] The Senate bill would have imposed fiduciary duties on swap dealers when they entered into swap transactions with pension plans. S. 3217 (amendment no. 3739), 111th Cong., 2d Sess. § 731. This provision was removed from the legislation in response to concerns expressed by plan sponsors.

[7] 29 C.F.R. § 2510.3-21 (proposed), 75 Fed. Reg. 65,263 (Oct. 22, 2010).

decisions on behalf of the plan. Many of the duties imposed on swap dealers and major swap participants under the Commission's proposed business conduct rules appear to fall within these broad categories. As a result, the proposed business conduct rules create a material risk that swap dealers and major swap participants will be classified as fiduciaries under the Labor Department's expanded definition.[8]

This situation is untenable. As ERIC has explained, it is unlawful for swap dealers to act as counterparties in transactions where they are identified as plan fiduciaries: they would incur substantial civil penalties under ERISA if they did so, and they would be liable to return any profits they earned on the transaction and make good any losses the plan incurred.[9] No swap dealer would enter into a transaction where there was even a remote risk of this kind of liability. Swap dealers have already told ERIC members that they will not enter into swap transactions with ERISA Title I plans if there is a risk that they will be classified as fiduciaries of the plans.

It is essential that the Commission and the Department of Labor coordinate their rules so that the business conduct standards do not require swap dealers and major swap participants to undertake duties that would cause them to be fiduciaries of ERISA Title I plans. Informal consultation between the agencies and non-binding statements in the preambles to the regulations are not sufficient to address this problem. Both sets of regulations must be clear that the Commission's regulation does not require conduct that would create fiduciary status under ERISA. If the agencies do not resolve this issue definitively and unambiguously, in published guidance on which all parties can rely, they will deprive ERISA Title I plans of an important tool for managing risk.

Similarly, the Commission should make clear that complying with the business conduct rules for Special Entities does not cause a swap dealer or major swap participant to be a fiduciary under any other body of law, such as the securities laws or common law. To the extent that coordination with any other agency (such as the Securities and Exchange Commission) is necessary to ensure this result, ERIC urges the Commission to undertake the necessary coordination. The sponsors of the Dodd-Frank Act recognized that it would be detrimental to the interests of Special Entities to impose fiduciary duties on swap dealers and major swap participants, and they engaged in a careful balancing of interests to ensure that the business conduct rules would not have this result. The Commission should interpret the rules in a way that carries out this intent.

2. The definition of a "Special Entity" should apply to trusts that hold the assets of employee benefit plans.

Swap dealers and major swap participants must satisfy special requirements when they deal with Special Entities. The Dodd-Frank Act defines a "Special Entity" to include "any employee benefit plan, as defined in section 3 of the Employee Retirement Income Security Act of 1974." The Commission has asked whether the definition of "employee benefit plans" should be clarified in any way.[10]

---

[8] ERIC's comments 4, 8, 9, and 10, below, discuss specific business conduct standards that raise a significant risk of imposing fiduciary status on swap dealers and major swap participants.

[9] *See* ERISA §§ 409, 502, 29 U.S.C. §§ 1109, 1132 *and* Internal Revenue Code § 4975.

[10] *See* Notice, 75 Fed. Reg. at 80,649.

The assets of an employee benefit plan governed by ERISA generally must be held in a trust.[11] Accordingly, if an employee benefit plan invests in swaps, it is the trust that owns the swaps, just as the trust owns the other assets of the employee benefit plan. Although the trust is an entity separate from the employee benefit plan, the trust exists solely to hold and invest the assets of the plan. For example, employee health plans are "employee benefit plans" as defined in section 3(3) of ERISA; but any assets that an employer sets aside to provide health benefits are typically held in a "voluntary employees' beneficiary association" ("VEBA"), which is a tax-exempt trust established pursuant to section 501(c)(9) of the Internal Revenue Code. In order to make the Special Entity definition meaningful as it applies to employee benefit plans, the Commission should make clear that the definition also includes any trust established to hold the assets of an employee benefit plan.

For the sake of efficiency, employee benefit plans sponsored by a single employer or group of related employers often pool their assets for investment purposes in a single trust, called a "master trust." Each participating plan generally owns an undivided proportionate interest in the trust's investments, including any investment in swaps. In a case where a master trust holds the assets of more than one employee benefit plan, the Commission should make clear that the business conduct requirements for Special Entities apply to the trust, and not to each separate employee benefit plan whose assets are held in the trust.

As a practical matter, any swap dealer or major swap participant will deal with an investment manager or other fiduciary that represents all of the plans participating in the master trust. When the swap dealer or major swap participant determines the status of the representative, makes disclosures, or takes other actions required by the business conduct rules, it should take these actions with respect to the trust, since it is the trust that will invest in the swaps. To apply the business conduct rules on a plan-by-plan basis would be burdensome and impractical, and would deprive the plans of the efficiencies they intended to achieve when they pooled their assets for investment purposes and placed them under the management of the master trust's investment managers. Accordingly, the definition of "Special Entity" should apply to the master trust, and not to the individual plans participating in the trust.

3. The "independent representative" requirement is limited to governmental entities and should never apply to ERISA Title I plans.

The business conduct standards established by section 4s(h) of the Commodity Exchange Act require a swap dealer or major swap participant entering into a swap transaction with a Special Entity to have a reasonable basis to believe that the Special Entity has a qualified independent representative.[12] The Commission has interpreted this requirement as applying to all Special Entities. To the contrary, however, the statute states that the "independent representative" requirement applies only 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. These subclauses refer to "a governmental entity (including the United States, a State, or a foreign government) or political subdivision of a governmental entity" and to "a multinational or supranational government entity." An ERISA Title I plan is not a governmental entity, and thus is not subject to the "independent representative" requirement. The regulation should acknowledge this fact.

---

[11] ERISA § 403(a), 29 C.F.R. § 1103(a).

[12] The Dodd-Frank Act § 731 (CEA § 4s(h)(5)(A)(i)).

In the preamble to the proposed regulation, the Commission explains that the independent representative requirement is ambiguous, because the cited subclauses of section 1a(18) of the Commodity Exchange Act include certain governmental entities that do not fall within the definition of "Special Entity," and do not include certain governmental entities that are "Special Entities."[13] If it is necessary to resolve an ambiguity in the statute, however, the Commission should do so by adopting the narrowest reading of the statute that gives effect to its intent—for example, by assuming that the reference to subclause (II) (multinational and supranational governmental entities) should instead refer to subclause (III) (federal and state agencies).

It is clear that the reference to section 1a(18) of the Commodity Exchange Act is intended to limit the "independent representative" requirement to governmental entities. There is no justification for ignoring the limitation entirely, as the proposed rule does, and applying to all Special Entities a requirement that Congress plainly limited to governmental entities. ERIC urges the Commission to narrow its interpretation of this requirement to conform to the statutory language.

4. A fiduciary of an ERISA Title I Plan should automatically qualify as an independent representative.

If, contrary to ERIC's recommendation (and, ERIC respectfully submits, contrary to the statute), the Commission applies the "independent representative" requirement to ERISA Title I plans, the Commission should at a minimum make clear that any employee benefit plan represented by an ERISA fiduciary will automatically satisfy this requirement. The statute lists seven criteria that are relevant in determining whether Special Entity has a qualified independent representative:

> The independent representative:
> ''(I) has sufficient knowledge to evaluate the transaction and risks;
> (II) is not subject to a statutory disqualification;
> (III) is independent of the swap dealer or major swap participant;
> (IV) undertakes a duty to act in the best interests of the counterparty it represents;
> (V) makes appropriate disclosures;
> (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 act of 1974, is a fiduciary as defined in section 3 of that Act (29 U.S.C. 1002)."

It is not clear whether the representative of an employee benefit plan subject to the fiduciary standards in Title I of ERISA must meet all seven criteria, or whether it is sufficient for the representative to comply with section 4s(h)(5)(A)(i)(VII), which requires that the representative act as an ERISA fiduciary. The Commission has asked for further comments on this question.[14]

---

[13] Notice, 75 Fed. Reg. at 80,651 n.106.

[14] *See* Notice, 75 Fed. Reg. at 80,653.

ERIC urges the Commission to provide that the requirements for representatives of Special Entities are satisfied with respect to ERISA Title I plans as long as the ERISA Title I plan is represented by an independent entity that acknowledges it is acting as a fiduciary. The Commission should make clear that a fiduciary representing a ERISA Title I plan in a swap transaction is not required to meet the six additional criteria described in section 4s(h)(5)(A)(i)(I)-(VI) of the Commodity Exchange Act and proposed 17 C.F.R. § 23.450(b)(1)-(6) (together, the "Independent Representative Criteria").

As ERIC explains in more detail below, ERISA imposes duties on the fiduciary of an ERISA Title I plan that are similar to, but more exacting than, the six Independent Representative Criteria. Federal courts often describe ERISA's fiduciary standards as "the highest known to the law."[15] Accordingly, if a swap dealer or major swap participant determines that a Special Entity is an ERISA Title I plan represented in the transaction by an ERISA fiduciary, the swap dealer or major swap participant should not be required to determine that the representative also satisfies the six Independent Representative Criteria. Imposing the Independent Representative Criteria in addition to the ERISA fiduciary standards will add complexity and cost to swap transactions and create a risk of inconsistent interpretation and enforcement, without enhancing in any way the protection afforded to ERISA Title I plans.

<u>Knowledge Requirement</u>. The first of the six Independent Representative Criteria requires the representative to have sufficient knowledge to evaluate the transaction and risks. Under Title I of ERISA, a plan fiduciary must act "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."[16] This "prudent man" standard has been interpreted to require the ERISA fiduciary to establish a sufficient base of knowledge or to seek appropriate advice prior to making any investment decision.[17] Because ERISA requires the fiduciary to have sufficient knowledge to understand the transaction and its risks, it is not necessary to impose a separate knowledge requirement under the proposed rule.

<u>Statutory Disqualification</u>. The second Independent Representative Criterion requires that the representative be free of statutory disqualifications. The proposed rule defines a statutory disqualification as "grounds for refusal to register or to revoke, condition or restrict the registration of any registrant or applicant for registration as set forth in Sections 8a(2) and 8a(3) of the [Commodity Exchange Act]." The grounds for refusal to register or revoke registration include conviction of various criminal acts and the imposition of certain civil and regulatory penalties.

---

[15] *See, e.g.*, *Braden v. Wal-Mart Stores, Inc.*, 588 F.3d 585, 598 (8th Cir. 2009); *Johnson v. Couturier*, 572 F.3d 1067, 1077 (9th Cir. 2009); *LaScala v. Scrufari*, 479 F.3d 213, 219 (2d Cir. 2007); *Gregg v. Transp. Workers of Am. Int'l*, 343 F.3d 833, 841 (6th Cir. 2003).

[16] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[17] *See, e.g.*, DiFelice v. U.S. Airways, Inc., 497 F.3d 410, 418 (4th Cir. 2007) ("Good faith does not provide a defense to a claim of a breach of these fiduciary duties; 'a pure heart and an empty head are not enough,'" (quoting *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir. 1983)); *Howard v. Shay*, 100 F.3d at 1488 (to enforce fiduciary duties under section 404 of ERISA, "the court focuses not only on the merits of [a] transaction, but also on the thoroughness of the investigation into the merits of [that] transaction.").

Title I of ERISA has its own set of statutory disqualifications for plan fiduciaries. Section 411 of ERISA provides that a person cannot act as an ERISA fiduciary if the person has been convicted of any one of a variety of crimes or regulatory violations.[18] Accordingly, any person or entity that represents an ERISA Title I plan in a swap transaction cannot be subject to a statutory disqualification under ERISA. Because ERISA's statutory disqualifications are designed specifically to address the fitness of a person or entity to act as a plan fiduciary, the ERISA statutory disqualifications should determine whether a person or entity is eligible to represent an ERISA Title I plan in a swap transaction.

Independence and Duty to the Special Entity. The third and fourth Independent Representative Criteria require the representative to be independent of the swap dealer or major swap participant, and to undertake a duty to act in the best interests of the Special Entity. Under ERISA, a fiduciary is bound by a strict duty of loyalty to the employee benefit plan it represents. The fiduciary must "discharge his duties with respect to the plan solely in the interest of the participants and beneficiaries and for the exclusive purpose of [providing benefits and paying plan expenses]."[19] In addition to this general duty of loyalty, which would prevent an ERISA fiduciary from acting in the interest of the swap dealer or major swap participant when entering in to a swap on behalf of the plan, ERISA specifically prohibits a fiduciary from "act[ing] in any transaction involving the plan on behalf of a party (or represent of party) whose interests are adverse to the interests of the plan . . . ."[20] ERISA also prohibits a fiduciary from entering into a transaction on behalf of a plan where the counterparty is an affiliate of the fiduciary.[21] Because ERISA clearly forbids a fiduciary from entering into a swap transaction with a related party and requires the fiduciary to act solely in the plan's interest, an ERISA fiduciary will necessarily satisfy the Independent Representative Criteria that address these points.

Disclosure to Plan. The fifth Independent Representative Criterion requires the representative to make appropriate and timely disclosures to the Special Entity. ERISA and the regulations promulgated under ERISA by the Department of Labor impose a comprehensive disclosure regime on ERISA Title I plans and the fiduciaries of such plans. The ERISA disclosure requirements are designed to ensure that plans and plan participants receive adequate information to make decisions, including decisions regarding the investment of plan assets. For example, the Department of Labor recently issued interim final regulations that require individuals and entities providing services to a

---

[18] Under ERISA § 411, 29 U.S.C. § 1111, a person generally may not serve as a plan fiduciary (or in any capacity that involves custody or control over a plan's assets) for thirteen years after the person is convicted of any of the following offenses: "[R]obbery, bribery, extortion, embezzlement, fraud, grand larceny, burglary, arson, a felony violation of Federal or State law involving substances defined in section 102(6) of the Comprehensive Drug Abuse Prevention and Control Act of 1970, murder, rape, kidnapping, perjury, assault with intent to kill, any crime described in section 9(a)(1) of the Investment Company Act of 1940, a violation of any provision of this Act, a violation of section 302 of the Labor-Management Relations Act, 1947, a violation of chapter 63 of title 18, United States Code, a violation of section 874, 1027, 1503, 1505, 1506, 1510, 1951, or 1954 of title 18, United States Code, a violation of the Labor-Management Reporting and Disclosure Act of 1959, any felony involving abuse or misuse of such person's position or employment in a labor organization or employee benefit plan to seek or obtain an illegal gain at the expense of the members of the labor organization or the beneficiaries of the employee benefit plan, or conspiracy to commit any such crimes or attempt to commit any such crimes, or a crime in which any of the foregoing crimes is an element."

[19] ERISA § 401(a)(1)(A), 29 U.S.C. § 1101(a)(1)(A).

[20] ERISA § 406(b), 29 U.S.C. § 1106(b).

[21] ERISA § 406(a), 29 U.S.C. § 1106(a).

plan to release detailed, comprehensible disclosures to the plan fiduciary before entering into or renewing a service relationship with the plan.[22] When a plan retains an investment manager or other investment fiduciary, the plan often imposes detailed additional disclosure requirements on the manager with respect to the manager's investment activities on behalf of the plan. It is not necessary for the Commission to add further disclosure requirements to the extensive existing disclosure regime under ERISA.

Fair Pricing and Appropriateness. The sixth Independent Representative Criterion requires the representative to evaluate the fair pricing and appropriateness of the swap and to provide written representations concerning these issues to the Special Entity. As ERIC has explained above, ERISA requires the fiduciary of an ERISA Title I plan to act solely in the plan's interest, and to act 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."[23] In order to comply with its duty under ERISA, the fiduciary must ensure that a swap transaction is appropriate for the plan, and that it is fairly priced. The requirement that the fiduciary provide written representations to the plan concerning these issues makes no sense in this context: since the fiduciary is acting on behalf of the plan with respect to the swap transaction, there is no one else who would have a reason to receive these representations on behalf of the plan.

ERIC recognizes that the Commission might believe no harm will come from requiring the representative of an ERISA Title I plan to satisfy the six Independent Representative Criteria in addition to satisfying ERISA's strict fiduciary standards, even though the Independent Representative Criteria largely duplicate requirements that exist in a more stringent form under ERISA. ERIC is concerned, however, that swap dealers and major swap participants will be unwilling to enter into swap transactions with ERISA Title I plans, or will substantially increase the cost of these transactions, if they are required to confirm that the six Independent Representative Criteria are satisfied with respect to the fiduciaries of ERISA Title I plans.

There is a material risk that the swap dealer or major swap participant will itself be deemed to be acting as a fiduciary under ERISA when it determines whether the representative of an ERISA Title I plan meets the six Independent Representative Criteria. ERISA defines "fiduciary" broadly to include any person who "exercises any authority or control respecting management or disposition of [a plan's] assets," or who "exercises any discretionary authority or discretionary control respecting management of such plan."[24] In the preamble to the proposed fiduciary regulation, the Labor Department confirms that advice concerning the management of a plan assets includes advice concerning the selection of persons to manage plan investments.[25] A person or entity that evaluates the fitness of a fiduciary to represent the plan in a swap transaction appears to fall within this broad definition.

---

[22] 29 C.F.R. § 2550.408b-2.

[23] ERISA § 404(a)(1)(B), 29 U.S.C. § 1104(a)(1)(B).

[24] ERISA § 3(21), 29 U.S.C. § 1002(21).

[25] 75 Fed. Reg. at p. 65,266.

Under ERISA, if a swap dealer or major swap participant is deemed to be discharging a fiduciary duty when it evaluates the plan fiduciary's fitness to represent the plan, and if it is judged to have failed to discharge this duty properly, the swap dealer or major swap participant will be personally liable to make good to the plan any losses to the plan that result from its breach of fiduciary duty, and to restore to the plan any profits that the swap dealer or major swap participant has realized as a result of the breach.[26] As ERIC has explained above, swap dealers have already told ERIC's members informally that they will be extremely reluctant to enter into swap transactions with ERISA Title I plans if there is any risk that these transactions will expose the swap dealers to fiduciary liability under ERISA.

5. The proposed rule correctly concludes that the representative of a Special Entity need not be independent of the Special Entity.

The Dodd-Frank Act requires swap dealers or major swap participants dealing with certain Special Entities[27] "to have a reasonable basis to believe that the counterparty that is a Special Entity has an independent representative that . . . is independent of the swap dealer or major swap participant."[28] By requiring that the Special Entity have an "independent representative" that is "independent" of the counterparty, the wording of the statute creates some uncertainty as to whether it is sufficient for the representative to be independent of the counterparty, or whether the representative must also be independent of the Special Entity.

Large companies often employ professional investment managers to manage the assets of the employer's employee benefit plans and the plans of its affiliates. Some companies establish subsidiaries (which are registered investment advisers) for the purpose of managing the employee benefit plan assets of the parent company and its affiliates, as well as the assets of unrelated entities; these subsidiaries are referred to as "in-house asset managers" or "INHAMs."[29] By using their own employees or an in-house asset manager to manage the assets of their employee benefit plans, these companies reduce the asset-management fees that their employee benefit plans otherwise would pay to a third-party manager, and they also gain direct control over the quality and performance of their plan asset managers. Accordingly, an employee benefit plan is often represented in a swap transaction by an investment manager that is an employee or an affiliate of the plan sponsor.

ERIC strongly supports the Commission's position that the Dodd-Frank Act requires the representative to be independent of the swap dealer or major swap participant, but does not require the representative to be independent of the Special Entity.[30] As the Commission has recognized, this

---

[26] *See* ERISA § 409, 29 U.S.C. § 1109.

[27] As explained above in ERIC's third comment, this requirement should be interpreted to apply exclusively to Special Entities that are governmental entities.

[28] The Dodd-Frank Act § 731 (CEA § 4s(h)(5)(A)(i)).

[29] *See* Department of Labor Prohibited Transaction Exemption 96-23. For a more detailed discussion of INHAMs, see comment 7, below.

[30] *See* Notice, 75 Fed. Reg. at 80,652 (discussing proposed 17 C.F.R. § 23.450(b)) ("This formulation of the duty is intended to clarify that 'independent' as it relates to a representative of a Special Entity means independent of the swap dealer or major swap participant, not independent of the Special Entity." (footnotes omitted)).

interpretation is consistent with Congress's intent.[31] In the following colloquy, Senators Lincoln and Harkin clarified that a plan sponsor's internal investment managers, including INHAMs, would satisfy the independent representative requirement:

> Mrs. LINCOLN. . . . . Those protections -- set forth in section 731 and section 764 of the conference report -- place certain duties and obligations on swap dealers and security-based swap dealers when they deal with special entities. One of those obligations is that a swap dealer or the security-based swap dealer entering into a swap or security-based swap with a special entity must have a reasonable basis for believing that the special entity has an independent representative evaluating the transaction. Our intention in imposing the independent representative requirement was to ensure that there was always someone independent of the swap dealer or the security-based swap dealer reviewing and approving 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?
>
> Mr. HARKIN. Yes, that is correct. We certainly understand that many special entities have internal managers that may meet the independent representative requirement. For example, . . . the named fiduciary or in-house asset manager -- INHAM -- for a pension plan may continue to approve swap and security-based swap transactions.[32]

As Congress recognized, INHAMs and other internal managers play a critical role in managing plan assets and provide cost-effective representation to employee benefit plans entering into swap transactions. If an employee benefit plan were required to hire an outside manager to represent the plan in swap transactions, this requirement would drive up the cost of the transactions without providing any additional protection for the plan. To the contrary, such a requirement would hamper the efforts of employers to provide efficient, sophisticated professional management for their employee benefit plan assets. Accordingly, ERIC supports the proposed rule stating that an employee benefit plan's representative does not need to be independent of the plan sponsor or other entities associated with the plan.

6. The representative of a Special Entity should be deemed to be "independent" of the swap dealer if the representative is an ERISA fiduciary.

Under the proposed rule, the representative of a Special Entity is not "independent" of a swap dealer or major swap participant if the representative has a "material business relationship" with the swap dealer or major swap participant. If the representative has received any compensation from the swap dealer or major swap participant, the swap dealer or major swap participant must ensure that the Special Entity is informed of the compensation and agrees in writing that the compensation does not constitute a material business relationship. The preamble to the proposed regulation states that this

---

[31] *See id.* at 80,652 & n.115.

[32] *See* 156 Cong. Rec. S5903 (daily ed. July 15, 2010).

requirement applies to compensation received within one year of an offer to enter into a swap; but the one-year limitation does not appear in the proposed regulation.[33]

This standard is unworkable as it applies to ERISA Title I plans. These plans often are represented in swap transactions by sophisticated investment advisers that might have a number of business relationships with a swap dealer, and might receive compensation from a swap dealer for reasons having nothing to do with the proposed swap transaction. ERISA strictly prohibits a plan's representative from entering into a transaction on behalf of a plan where the counterparty is an affiliate of the plan's representative, or where the plan's representative has any conflict of interest.[34] Regulations under ERISA require the plan's representative (not the swap dealer) to disclose to the plan any compensation that the plan's representative receives from a third party in connection with the representative's services as a fiduciary of the plan.[35] These requirements are specifically designed and strictly enforced to protect the plan's interests. Accordingly, in any situation in which an ERISA Title I plan is represented in a swap transaction by a fiduciary who is subject to ERISA's standards of conduct, the plan should automatically be deemed to have an independent representative, without any further inquiry into the fiduciary's relationship to the swap dealer or major swap participant.

7. A QPAM or INHAM acting for an ERISA Title I plan should automatically qualify as an independent representative.

ERISA Title I plans frequently employ large, sophisticated financial institutions to provide professional asset management services with respect to the plan's assets. These institutions are generally banks or registered investment advisers; they may be affiliated with the plan sponsor (an "in-house asset manager" or "INHAM"), or unaffiliated (a "qualified professional asset manager" or "QPAM"). When an ERISA Title I plan enters into a swap transaction, it is often represented by an INHAM or a QPAM, which provides the necessary financial expertise to evaluate the transaction and satisfies certain conflict of interest provisions imposed by ERISA. If the Commission does not adopt ERIC's recommendations to exempt ERISA fiduciaries from the Independent Representative Criteria, the Commission should adopt a safe harbor making clear that a swap dealer or major swap participant has a reasonable basis to believe that a Special Entity has an appropriate independent representative when the employee benefit plan is represented in the transaction by a QPAM or an INHAM.

<u>QPAMs</u>. Under Department of Labor Prohibited Transaction Exemption 84-14 ("PTE 84-14"), in order to act as a "qualified professional asset manager," a person must meet certain criteria with respect to financial sophistication and investment expertise. In particular, (1) the QPAM must be a regulated financial entity, such as an "investment adviser" under the Investment Advisers Act of 1940, bank, savings and loan, or insurance company; (2) if the QPAM is a registered investment adviser, it must have at least $85 million in assets under management; and (3) the QPAM must have equity or net worth of $1 million or a guarantee of all liabilities, including fiduciary liabilities, by an affiliate with such level of equity.

---

[33] *See* Notice, 75 Fed. Reg. at 80,652 (discussing proposed 17 C.F.R. § 23.450(c)).

[34] ERISA § 406, 29 U.S.C. § 1106.

[35] 29 C.F.R. § 2250.408b-2(c).

INHAMs. An INHAM is a subsidiary or affiliate of the employer that sponsors the plan. An INHAM must meets criteria similar to those applicable to a QPAM.[36] An INHAM must be a registered investment adviser under the Investment Advisers Act of 1940, must have at least $50 million in assets under management. In addition, the INHAM is subject to an annual compliance audit by an independent auditor, adding another layer of oversight to the INHAM's actions.

When a QPAM or INHAM negotiates the terms of a transaction, including a swap, the transaction must meet certain other criteria that demonstrate the QPAM or INHAM's independence from the transaction counterparty. In particular, the counterparty to the transaction (referred to as the "party in interest") cannot be "related to" the QPAM or INHAM[37] and cannot have any authority over the QPAM's contract with the plan. In addition, the terms of the transaction must be at least as favorable to the plan as those generally available in arm's length transactions between unrelated parties.

In adopting heightened business conduct standards for swap dealers and major swap participants in transactions with Special Entities, Congress intended to protect investors that do not necessarily have the level of expertise to evaluate a swap transaction internally and might rely on the swap dealer to provide advice concerning the suitability of the transaction. This concern does not apply to an ERISA Title I plan that is represented by a QPAM or INHAM: by definition, the QPAM or INHAM must demonstrate a significant level of expertise and independence from the counterparty. Accordingly, the Commission should confirm that a QPAM or INHAM does not need to meet additional Independent Representative Criteria in order to represent an ERISA Title I plan in a swap transaction, and that the swap dealer or major swap participant can discharge its responsibility by confirming that the plan's representative is a QPAM or INHAM.

8. Swap dealers should never be classified as "advisors" to ERISA Title I plans.

If a swap dealer acts as an "advisor" to a Special Entity, the Dodd-Frank Act imposes an obligation on the swap dealer to act in the "best interests" of the Special Entity. If a swap dealer is classified as an "advisor" to an ERISA Title I plan, however, there is a substantial risk that the dealer

---

[36] *See* Department of Labor Prohibited Transaction Exemption 96-23. The Labor Department recently amended Prohibited Transaction Exemption 84-14 to permit a QPAM to manage assets of a plan sponsored by the QPAM or an affiliate, provided that the QPAM adopts written compliance policies and satisfies an annual audit requirement similar to the requirement for INHAMs. 75 Fed. Reg. 38,837 (July 6, 2010).

[37] Under PTE 84-14, "[a] QPAM is "related" to a party in interest for purposes of section I(d) of this exemption if, as of the last day of its most recent calendar quarter: (i) the QPAM owns a ten percent or more interest in the party in interest; (ii) a person controlling, or controlled by, the QPAM owns a twenty percent or more interest in the party in interest; (iii) the party in interest owns a ten percent or more interest in the QPAM; or (iv) a person controlling, or controlled by, the party in interest owns a twenty percent or more interest in the QPAM. A party in interest also is "related" to a QPAM if: (i) a person controlling, or controlled by, the party in interest has an ownership interest that is less than twenty percent but greater than ten percent in the QPAM and such person exercises control over the management or policies of the QPAM by reason of its ownership interest; (ii) a person controlling, or controlled by, the QPAM has an ownership interest that is less than twenty percent but greater than ten percent in the party in interest and such person exercises control over the management or policies of the party in interest by reason of its ownership interest." An INHAM is deemed to be "related to" a party in interest "if the party in interest (or a person controlling, or controlled by, the party in interest) owns a five percent or more interest in the INHAM or if the INHAM (or a person controlling, or controlled by, the INHAM) owns a five percent or more interest in the party in interest." PTE 96-23.

will also be viewed as a fiduciary of the plan under ERISA, a status that will preclude it from acting as a counterparty in the swap transaction. In order to avoid this dilemma, the Commission should make clear that a swap dealer is never deemed to act as an "advisor" to an ERISA Title I plan.

Under ERISA, any person or entity that provides investment advice to an ERISA Title I plan for compensation, or that has any responsibility to do so, is deemed to be a fiduciary.[38] The Department of Labor's recent proposed regulation significantly expands the circumstances in which advisers to ERISA Title I plans are considered to be fiduciaries.[39] For example, under the proposed regulation, if a registered investment advisor "makes recommendations as to the advisability of investing in" securities or other property, the advisor is a fiduciary unless it can demonstrate that the person representing the ERISA Title I plan in the transaction should have known that the advisor's interests were adverse to the interests of the plan and that the advisor was not undertaking to provide impartial investment advice.

The proposed business conduct rule states that a swap dealer acts as an "advisor" when the dealer "recommends" a swap or trading strategy to a Special Entity, but not when the dealer merely provides general information or supplies terms in response to a competitive bid. The proposed rule does not otherwise define what it means to be an "advisor" to a Special Entity. It will be difficult for a swap dealer to be sure that it is not classified as an "advisor" under this broad standard; and once the swap dealer is classified as an advisor, it must gather a variety of information about the Special Entity's circumstances and make a determination that the swap transaction is in the best interest of the Special Entity.

The advisor's duty to act in the best interest of the counterparty entails a substantial risk that the swap dealer will be regarded as a fiduciary of a Special Entity that is an ERISA Title I plan. The Commission noted in the preamble that it had consulted with Labor Department staff, who advised that any determination of status under the Dodd-Frank Act is "separate and distinct" from the determination of fiduciary status under ERISA.[40] ERIC respectfully disagrees with this statement. "Advisor" status under the business conduct rule is not coextensive with fiduciary status under ERISA, but the two standards are closely related. Both standards focus on the question whether the swap dealer has "recommended" a swap, a term that could include a wide range of conduct. Under the Labor Department's proposed rule, an advisor that recommends a swap will be able to avoid fiduciary status only if it is clear in the circumstances that the advisor's interests are adverse to the interests of the plan; but it will be impossible for a swap dealer to make this showing if it has a duty under the business conduct rules to act in the plan's best interest.

No swap dealer will enter into a swap transaction with an ERISA Title I plan if there is a risk that the swap dealer will be classified as a plan fiduciary under ERISA or under any other law. The status of fiduciary is incompatible with the swap dealer's role as a counterparty in the transaction, and fiduciary status entails significant potential liability if the dealer is found to be in breach of its duty. As ERIC has explained, a dealer who is classified as an "advisor" to an ERISA Title I plan under the business conduct rules faces a substantial risk that it will also be deemed to be a fiduciary under ERISA. Accordingly, a swap dealer that enters into swap transactions with ERISA Title I plans must

---

[38] ERISA 3(21)(A)(ii), 29 U.S.C. § 1002(21)(A)(ii).

[39] 29 C.F.R. § 2510.3-21(c) (proposed), 75 Fed. Reg. 65,263 (Oct. 22, 2010).

[40] 75 Fed. Reg. at 80,650 n.101.

have a high degree of assurance that it will not be considered an "advisor" to the plan under the business conduct rules.

ERIC urges the Commission to provide that a swap dealer is never an "advisor" to an ERISA Title I plan as long as the plan is represented in the transaction by an entity that acknowledges it is a fiduciary of the plan. As explained above, a plan fiduciary has a statutory duty under ERISA to act solely in the interest of the plan, and to bring to bear the judgment that a prudent person familiar with the transaction would use. A plan fiduciary is strictly prohibited from representing the plan in a transaction in which the fiduciary has any adverse interest. Because the fiduciary is obligated to act in the best interests of the ERISA Title I plan, there is no need for the Commission to impose a duty on the swap dealer also to act in the plan's best interest.

If the Commission does not accept ERIC's recommendation automatically to exclude swap dealers from "advisor" status when they enter into swap transactions with ERISA Title I plans, the Commission should at a minimum permit the parties to contract out of "advisor" status. If the plan fiduciary concludes that it is in the plan's best interest to make clear that the swap dealer is not an "advisor" to the plan, and the parties enter into a written agreement to this effect, the swap dealer should not have any responsibility to act in the plan's best interest. This approach would be consistent with the provision in the Labor Department's proposed fiduciary status regulation, which allows the parties to make clear that the dealer's interests are adverse to those of the plan and that the dealer is not acting as a fiduciary of the plan.

9. The proposed rule should clarify when a swap dealer is an "advisor."

As ERIC explained in the preceding comment, it will be important for swap dealers to avoid being classified as "advisors" when they enter into swap transactions with ERISA Title I plans. ERIC recommends that swap dealers never be classified as "advisors" to ERISA Title I plans, or that they be permitted to contract out of "advisor" status. If the Commission does not accept these recommendations, however, it must make clear what conduct causes a dealer to be classified as an "advisor," so that the dealer can avoid inadvertently becoming an "advisor."

The proposed rule should define much more precisely and much more narrowly the circumstances in which a swap dealer will be deemed to "recommend" a swap or trading strategy. According to the preamble, a recommendation "would include any communication by which a swap dealer or major swap participant provides information to a counterparty about a particular swap or trading strategy that is tailored to the needs or characteristics of the counterparty."[41] This definition is broad enough to include almost any information provided by a swap dealer except the most generic description of the swap transaction. ERIC is concerned that the broad and vague language of the proposed rule will have the perverse effect of discouraging swap dealers from providing information that would be useful to the representatives of ERISA Title I plans, out of a concern that information addressing the plan's particular circumstances will be construed as a "recommendation."

Under the disclosure standards in the proposed rule, a swap dealer is *required* to provide information that appears to fall within the preamble's broad definition of a recommendation, such as a scenario analysis designed in consultation with the counterparty.[42] At a minimum, the

[41] Notice, 75 Fed. Reg. at 80,647.

[42] *See* 17 C.F.R. § 23.431 (proposed).

proposed rule should state that information required to be provided under any applicable statute, rule, or regulation (including, but not limited to, the Commission's business conduct standards) does not constitute a "recommendation" regardless of whether it is tailored to the counterparty's individual circumstances.

The proposed rule should make clear that a swap dealer is not deemed to "recommend" a swap strategy if the swap dealer describes a particular strategy that might be beneficial to the ERISA Title I plan, but an independent ERISA fiduciary evaluates the strategy and reaches the final decision whether the plan should adopt the strategy. In these circumstances, it is clear that the ERISA Title I plan is not relying on the swap dealer's recommendation, but instead is relying on its own fiduciary to evaluate the merits of the transaction.

The proposed rule also should make clear that a dealer does not become an "advisor" through any actions *other than* recommending a swap or trading strategy. At present, the proposed rule states that recommending swap transactions causes a dealer to be an advisor, but it implies that other conduct not identified in the proposed rule might also confer advisor status. The preamble appears to confirm this impression: it says, "The proposed definition does not address what it means to act as an advisor in connection with any other dealings between a swap dealer and a Special Entity." If there are other types of conduct that might cause a swap dealer to be classified as an "advisor" to a Special Entity, the Commission should describe them clearly and objectively in the regulation. Significant obligations and potential adverse consequences flow from a swap dealer's status as an "advisor" to a Special Entity; the Commission should not leave the parties to guess what conduct might cause the swap dealer to be considered an "advisor."

10. The parties should be permitted to modify the requirement to provide a daily mark for uncleared swaps.

The proposed rule requires a swap dealer or major swap participant to provide a counterparty with a daily mark for uncleared swaps. The daily mark must be the mid-market value of the swap, excluding amounts for profit, credit reserve, hedging, funding, liquidity, or any other costs or adjustments. The daily mark must be provided on each business day as of the close of business "or such other time as the parties agree in writing."

The daily mark requirement will be beneficial to many counterparties. In some cases, however, counterparties and swap dealers have already agreed that the dealer will provide valuation information for uncleared swaps that is calculated in a manner different from the calculation prescribed by the "daily mark" requirements. In other cases, counterparties have developed their own sophisticated systems for determining the value of swaps; these counterparties do not wish to receive a daily mark calculated under a different system that provides a conflicting value for the swap. In addition, the requirement to provide a "daily mark" raises a concern that the swap dealer or major swap participant will inadvertently become a fiduciary of an ERISA Title I plan, since the Labor Department's proposed regulations confer fiduciary status on any person who provides advice concerning the value of the plan's property.[43] Accordingly, the proposed rule should make clear that

[43] 29 C.F.R. § 2510.3-21(c)(1)(i)(A)*(1)* (proposed). The proposed regulation includes an exception for general valuation information provided to meet disclosure requirements of ERISA or the Internal Revenue Code, but does not exempt valuation information provided to meet other regulatory requirements, such as the Commission's business conduct standards.

the parties may agree in writing to provide valuation information different from the daily mark described in the regulation, or may agree in writing that the swap dealer or major swap participant is not required to provide valuation information for a particular uncleared swap.

*   *   *   *   *

ERIC appreciates the opportunity to submit these comments. If we can be of further assistance, please let us know.

Sincerely,

Mark J. Ugoretz
President & CEO

cc. Phyllis C. Borzi, Assistant Secretary of Labor,
Employee Benefits Security Administration