# Managed Funds Association

The Voice of the Global Alternative Investment Industry

Washington, D.C. | New York

March 21, 2022

**Via Electronic Mail:** rule-comments@sec.gov

Vanessa A. Countryman
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

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

Dear Ms. Countryman,

Managed Funds Association[1] ("**MFA**") appreciates the opportunity to provide comments to the Securities and Exchange Commission ("**SEC**" or "**Commission**") on its proposed "Prohibition Against Fraud, Manipulation, or Deception in Connection with Security-Based Swaps" ("**Proposal**").[2] This letter provides comments on the SEC's re-proposed Rule 9j-1 ("**Rule 9j-1**") under the Securities and Exchange Act of 1934 (the "**Exchange Act**"), which is intended to prevent fraud, manipulation, and deception in connection with effecting transactions in, or attempting to induce the purchase or sale of, any security-based swap. MFA's comments on the SEC's proposed Rule 10B-1, as set forth in the Proposal, are addressed in a separate comment letter.[3]

We commend the Commission for its continued efforts to improve investor protection, integrity and competitiveness in securities and in-scope derivatives markets. We also support the Commission's goal of preventing fraud, manipulation and deception in security-based swap markets. However, for the reasons set forth below, we are concerned that re-proposed Rule 9j-1, in its current proposed form, exceeds the Commission's statutory authority, will unnecessarily impede the market for security-based swaps, as well as the markets for the underlying reference securities, and will have a significant adverse impact on market liquidity and the effectiveness of security-based swap markets. Security-based swap markets serve a critical

---

[1] MFA represents the global alternative investment industry and its investors by advocating for regulatory, tax and other public policies that foster efficient, transparent, and fair capital markets. MFA's more than 150 members collectively manage nearly $1.6 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time. MFA has a global presence and is active in Washington, London, Brussels, and Asia.

[2] Exchange Act Release No. 34-93784 (December 15, 2021), 87 Fed. Reg. 6652 (February 4, 2022).

[3] Managed Funds Association, *Comment Letter re Notice of Proposed Rulemaking on Position Reporting of Large Security-Based Swap Positions; File No. 37-32-10* (March 21, 2022).

role in facilitating risk-shifting between sophisticated market participants, allowing them to effectively hedge their exposures. In doing so, security-based swap markets promote efficient capital formation and reduce the cost of capital for issuers of the underlying securities. For the reasons set forth more fully below, we believe that re-proposed Rule 9j-1 will deter market participants from entering into security-based swap transactions that are necessary or appropriate for their hedging or other portfolio objectives in order to avoid potentially exposing themselves to liability merely for performance of their contractual obligations. This will operate not only to the detriment of security-based swap market participants, but also issuers, who will face increased costs of debt and reduced availability of capital, particularly in instances where the issuer is in financial distress.

While we appreciate that the Commission has proposed safe harbors to protect against such exposure, we respectfully submit that these provisions are too limited and uncertain to be effective, and we note that the Proposal does not include the types of affirmative defenses afforded under other antifraud provisions. As a result, we believe that re-proposed Rule 9j-1 will discourage market participants from entering into security-based swap contracts and will, as a result, reduce liquidity in security-based swap markets, exacerbate risks for market participants and increase issuers' cost of capital. Instead, as described further below, we respectfully urge the Commission to adopt a more limited and appropriate rule that will further the goals of the Proposal, while avoiding the imposition of liability for good faith, ordinary-course actions and mitigating the negative outcomes described herein. Specifically, we recommend that the Commission modify re-proposed Rule 9j-1 to conform with its governing statute by clarifying that the terms, "purchase" and "sale" do not include interim performance obligations and that the re-proposed rule does not apply to the purchase or sale of underlying securities. At a minimum, re-proposed Rule 9j-1 should be revised to extend the scienter standard applicable to alleged violations of re-proposed Rules 9j-1(a)(1) and (2) to also apply to re-proposed Rules 9j-1(a)(3) and (4); provide a safe harbor for trading in security-based swaps by independent business units that are restricted from accessing material nonpublic information ("**MNPI**") by information barriers; extend Rule 10b5-1 affirmative defenses to re-proposed Rule 9j-1; and clarify the scope of actions covered under Rule 9j-1(b).

## I. Summary

The issues presented by re-proposed Rule 9j-1 are of great concern to us and our members and we appreciate this opportunity to share our views. The following is a summary of our principal positions on the Proposal, which are explained more fully below.

1. The scope of re-proposed Rule 9j-1 exceeds the Commission's statutory authority to regulate the "purchase" or "sale" of security-based swaps by including within the scope of the prohibitions interim actions in performance of contractual obligations during the life cycle of a security-based swap.

2. The proposed safe harbors are overly restrictive and not sufficiently clear, and do not adequately protect from liability market participants engaged in

good-faith performance of their obligations under security-based swap agreements.

3. Re-proposed Rules 9j-1(a)(3) and (4) should include a scienter standard to account for the unique aspects of security-based swap transactions.

4. The Commission should extend to potential violations of re-proposed Rule 9j-1 the affirmative defenses that are available under Rule 10b5-1.

5. The scope of proposed Rule 9j-1(b) is overly broad and will have a chilling effect on the security-based swap markets and the markets for the underlying securities.

## II. The scope of re-proposed Rule 9j-1 exceeds the Commission's statutory authority to regulate the "purchase" and "sale" of security-based swaps by including within the scope of the prohibitions interim actions in performance of contractual obligations during the life cycle of a security-based swap.

In response to the Commission's initial proposed Rule 9j-1[4] (the "**Original Proposal**") in November 2010, we submitted a comment letter (our "**2010 Comment Letter**")[5] expressing our serious concern that the Commission exceeded its Congressionally delegated authority by extending the scope of proposed Rule 9j-1 to cover the interim performance of contractual obligations by parties to a security-based swap during the term of the agreement. The current Proposal similarly includes ongoing performance within its scope and so continues to exceed the Commission's authority and, therefore, raises the same concerns as noted in our 2010 Comment Letter. While we appreciate the safe harbors introduced by the Commission in re-proposed Rule 9j-1, which attempt to address certain of our concerns, these provisions, for the reasons explained in Part III below, are too narrow, do not provide market participants with sufficient certainty as to their applicability, and do not adequately mitigate the detrimental impact of the scope of re-proposed Rule 9j-1. For these reasons, we respectfully submit that the Commission should adhere to Congress's express intent, and to the clear statutory limits on its authority, and modify re-proposed Rule 9j-1 accordingly by excluding from its scope interim actions taken in performance of contractual obligations during the life cycle of a security-based swap.

---

[4] *Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps*, Exchange Act Release No. 34-63236 (Nov. 3, 2010), 75 F.R. 68560 (Nov. 8, 2010).

[5] Managed Funds Association, Comment Letter *Re Notice of Proposed Rulemaking on the Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps; File No. S7-32-10* (December 23, 2010), available at http://www.managedfunds.org/downloads/MFA%20Final%20Comment%20Letter%20on%20SEC%20Proposed%20Rule%209j-1.pdf, and incorporated herein as Appendix A.

The Commission itself appears to recognize the problems that may be caused by re-proposed Rule 9j-1, not only in its proposal of safe harbors, but also by noting that the Proposal is intended only to capture fraudulent or manipulative conduct that "alters any material terms of the security-based swap … or has a material impact on any payment or delivery under the security-based swap, such that it would not be consistent with what a reasonable person would have expected to pay, deliver, or receive absent such conduct."[6] This limitation, however, and the use of a reasonableness standard, is not reflected in the language of either re-proposed Rule 9j-1(a) or the safe harbors thereunder, and will therefore be of limited (or no) utility to market participants.

In this regard, we note that, in referring to a "reasonableness" standard with respect to the distinction between a new and existing transaction, the Commission cites to the 2012 joint release with the Commodity Futures Trading Commission ("**CFTC**"), in which the agencies jointly adopted rules with respect to the definitions of "swaps" and "security-based swaps."[7] The Commission's point in citing to the 2012 Release is that, in that instance, the Commission and the CFTC asserted that changes to the terms of a transaction that result from "an exercise of discretion and not through predetermined criteria or a predetermined self-executing formula" would be considered a new transaction, separately subject to the rules governing swaps and security-based swaps.[8] That statement in the 2012 Release, however, dealt with actual changes to material terms of a transaction, which resulted in the creation of a new transaction.[9] Here, the Commission's Proposal purports to cover simple ongoing performance of previously agreed-upon obligations that, under any reasonable interpretation, cannot be considered new transactions. We agree that re-proposed Rule 9j-1 should be applicable, consistent with the 2012 Release, if the parties to a security-based swap transaction make changes to material terms that result in the creation of a new transaction. However, that is not consistent with the scope and effect of Rule 9j-1, which, as proposed, would apply to every interim performance obligation (including, for example, daily margin payments), regardless of whether it results from changes that give rise to a new transaction.

A plain reading of the statutory text further demonstrates that the Proposal exceeds the authority granted by Congress to the Commission. Section 763(g) of the Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), which enacted Section 9(j) of the Exchange 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-

---

6 Proposal, at p. 6661.

7 *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48207, 48286 (Aug. 13, 2012) (the "**2012 Release**"); *see* Proposal at p. 6661, n.82.

8 *Id*.

9 *See* 2012 Release, at p. 48286.

> based swap, in connection with which such person engaged in any fraudulent, deceptive or manipulative act or practice . . . .[10]

Prior to the enactment of the Dodd-Frank Act, the definition of "purchase" included "any contract to buy, purchase, or otherwise acquire"[11] and the definition of "sale" included "any contract to sell or otherwise dispose of."[12] The Dodd-Frank Act amended these definitions by adding that:

> For security-based swaps, such terms include the execution, termination (prior to its scheduled maturity date), assignment, exchange, or similar transfer or conveyance of, or extinguishing of rights or obligations under, a security-based swap . . . .[13]

In that statutory context, re-proposed Rule 9j-1, like the Original Proposal, exceeds the Commission's delegated authority to regulate the "purchase or sale" of securities by extending the scope of re-proposed Rule 9j-1 to:

> any action to exercise any right, or any action related to performance of any obligation, under any security-based swap, including in connection with any payments, deliveries, rights, or obligations or alterations of any rights thereunder . . . .[14]

Had Congress intended to include actions related to the ongoing performance of obligations under a security-based swap agreement, it would have expressly done so in the Dodd-Frank Act or subsequent legislation, particularly given that it amended the definitions of "purchase" and "sale" to reflect security-based swaps. In so doing, Congress made a determination to limit the covered actions to "execution," "termination," "exchange," or "extinguishing" of rights or obligations under a security-based swap agreement.[15] It would be anomalous, and contrary to

---

[10] Dodd-Frank 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).

[11] 15 U.S.C. 78c(a)(13).

[12] 15 U.S.C. 78c(a)(14).

[13] Dodd-Frank Act, Sections 761(a)(3) and (a)(4) (amending Sections 3(a)(13) and 3(a)(14) of the Exchange Act). *See also* Dodd-Frank Act, Section 768(a)(3)(amending Section 2(a)(18) of the Securities Act).

[14] Proposed Rule 240.9j-1(a).

[15] *See* Managed Funds Association, Comment Letter *re Notice of Proposed Rulemaking on the Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps; File No. S7-32-10* (March 29, 2011), Part III, available at http://www.managedfunds.org/wp-content/uploads/2011/06/3.29.11-MFA-SEC-Antifraud-Ltr.final_.3.29.2011.pdf, and incorporated herein as Appendix B. *See also* 2010 Comment Letter, Parts II and III, for further discussion of the appropriate interpretation of "execution," "termination," "exchange" and "extinguishment" pursuant to the Dodd-Frank Act.

established doctrines of statutory construction, to incorporate language used elsewhere in the same statute and yet give it a substantially broader meaning without expressing an intent to do so. Rather, in clarifying the definition of "purchase" and "sale" in the context of security-based swaps, Congress made the conscious decision to limit the scope of security-based swap transactions covered under Section 763(g) of the Dodd-Frank Act so as to specifically exclude ongoing obligations between parties, which are governed by the contract between the two parties, and which do not constitute or involve execution, termination, assignment, exchange, transfer or extinguishment of rights.[16]

In fact, the approach taken by Congress with respect to Section 9(j) is not only clear in itself, it also aligns with the well-established principle that the Commission's antifraud authority is limited to the purchase or sale of securities. For example, both Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act of 1933 (as amended, the "**Securities Act**") limit the scope of the Commission's antifraud authority in a similar manner, notwithstanding the fact that many types of traditional securities involve continuing payment or other interim obligations that are integral to the terms of such securities.[17] Nevertheless, neither the Commission nor the courts have applied the antifraud provisions to such performance in accordance with the terms of these securities. The Commission's current Proposal, therefore, is not only beyond its authority, but also represents an unprecedented application of the securities laws. We respectfully submit that the Commission is misreading the statutory language and congressional intent and is attempting to create an expansive scope for Rule 9j-1 that is unsupported by, and in fact contrary to, the history, purpose and application of the antifraud provisions of the securities laws.

We note further that courts have supported a narrow construction of the term "purchase" by pointing out that, in order for an action to be included within the scope of this term, it must involve "a significant change in the nature of the investment or in the investment risks as to amount to a new investment."[18] This principle is consistent with the position taken by the SEC and CFTC in the 2012 Release, which, as noted, the Commission has misapplied in this context to extend to situations in which there is no material change or new transaction. The rights or

[16] Courts have held that rules and regulations promulgated by the Commission pursuant to delegated authority from Congress must retain a close nexus between the prohibited conduct and the statutory aims. *See, e.g.*, *U.S.* v. *Chestman*, 947 F.2d 551, 559 (2d Cir. 1991); *SEC* v. *S. Peters*, 978 F.2d 1162, 1166 (10th Cir. 1992). By enacting rules that purport to regulate interim obligations during the life of a security-based swap, the Commission is regulating actions that do not have a close nexus to the conduct Congress was expressly attempting to curtail, namely fraud in connection with the execution, termination, assignment, exchange, transfer or extinguishment of rights under a security-based swap agreement. *See* 2010 Comment Letter, Part II, for further discussion on the scope of the Commission's statutory authority under Section 9(j) of the Exchange Act.

[17] Section 10(b) of the Exchange Act, as amended, explicitly applies only "in connection with the *purchase or sale* of any security… or any securities-based swap agreement" (codified 15 U.S.C. 78j(b)) (emphasis added); Section 17(a) of the Securities Act applies only in the "*offer or sale* of any securities (including security-based swaps) or any security-based swap agreement" (codified 15 U.S.C. 77q(a)) (emphasis added).

[18] *See, e.g.*, *Abrahamson* v. *Fleschner*, 568 F. 2d 862, 868 (2d Cir. 1977), *cert denied*, 436 U.S. 905, 913 (1978).

obligations of parties to a security-based swap, following the execution of the security-based swap and prior to its termination, are determined by negotiation between the parties, documented in the contract reflecting the security-based swap transaction and subject to the protections negotiated between the parties. The performance of interim obligations pursuant to a security-based swap contract, such as periodic payments, margin payments or notices, do not alter the parties' preexisting contractual obligations or the pre-determined allocation of risk between the parties and, therefore, cannot constitute a "new investment," within the meaning of the terms "purchase" or "sale."

There also is no precedent or support for the Commission to adopt a broad interpretation of the phrase "to effect any transaction in" in Section 763(g), as a basis for including interim performance obligations within the scope of proposed Rule 9j-1, as this has not been the traditional and longstanding understanding of that statutory phrase. The language "to effect any transaction in" is used elsewhere in the Securities Act and Exchange Act and has never been understood to apply to conduct occurring during the term of a security unless a new investment decision is made, which is not the case with interim performance obligations.[19] Interpretations of "effect[ing] a transaction," therefore, have been limited to the process leading to the purchase or sale of a security.[20]

Moreover, we respectfully submit that this determination by Congress to limit the Commission's authority reflected its intention to ensure that the scope of the antifraud provisions would not adversely affect the markets for security-based swaps. Security-based swap agreements are typically negotiated between sophisticated counterparties for the purpose of accomplishing specific hedging or portfolio objectives of the parties. In crafting the scope of the antifraud provisions, Congress recognized that the types of transactions for which protections are afforded to market participants through those provisions must be carefully balanced against the need to avoid undue restrictions that would materially impair the ability of market participants to use security-based swaps to perform their important functions. The Commission cannot, should not, and may not substitute its judgment for that of Congress.

In fact, by contravening the intent of Congress, the Proposal as drafted exposes market participants to unwarranted risks and uncertainty that will have significant adverse effects on security-based swap markets and will substantially undermine the ability of market participants to utilize security-based swaps for their intended purposes. Specifically, if the proposed antifraud

---

[19] 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 (*See* 15 U.S.C. 78o(a)(1), 78o(c)). Variants on "effect a transaction" also appear throughout Section 9 of the Exchange Act (*See, e.g.*, 15 U.S.C. 78i(a)). Generally, this language appears to be used interchangeably with "purchase or sale."

[20] *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).

rule can be applied to any action or omission "*related to* performance of any obligation," market participants will undoubtedly seek to limit the scope of their transactions, and the terms of such transactions, in order to mitigate their exposure to liability under the rule. Indeed, we expect that some parties will terminate their involvement in the security-based swap markets entirely because of concerns over the potential for actually receiving MNPI during the term of the transactions, which would impact their ability to comply with contractual obligations, or out of concern of being deemed to have violated re-proposed Rule 9j-1 because an independent trading desk at the same firm is in possession of MNPI. This will reduce liquidity in security-based swap markets and, by restricting hedging opportunities, have a material adverse effect on the availability and cost of capital for issuers.

Further, to the extent that lenders are unable to hedge their positions with security-based swaps, thereby forcing them to assume increased exposure under re-proposed Rule 9j-1, they are less likely to lend to commercial borrowers, which will increase the cost of debt for borrowers. For those parties that continue to enter into security-based swap transactions, the Proposal could substantially interfere with the parties' performance of their contractual rights and obligations by placing them in the untenable position of choosing between potential exposure under the antifraud provisions and default on contractually mandated actions. Nothing in the statute, the history of the antifraud provisions or the congressional grant of authority to the Commission suggests that Congress intended to subject market participants to that irreconcilable situation.

We further question the Commission's authority to enact antifraud rules under Section 9(j) of the Exchange Act that relate to the purchase and sale of reference securities underlying security-based swap contracts. Section 9(j) specifically provides the Commission with the statutory authority to prescribe rules that address fraudulent, deceptive or manipulative practices to "effect any transaction in, or to induce or attempt to induce the purchase or sale of, any <u>security-based swap</u>."[21] Proposed Rule 9j-1(b), would apply to actions taken in underlying securities markets as well. Application of proposed Rule 9j-1(b) in this way would result in otherwise permissible conduct in the securities market being deemed to be in violation of re-proposed Rule 9j-1 merely because the same entity also holds a security-based swap position. Moreover, this exposure could arise notwithstanding the fact that (as discussed further below in Part V) there are information barriers in place between the business unit trading in security-based swap markets and the business unit trading in the underlying securities markets at the same firm. This will also lead to regulatory arbitrage between existing antifraud rules applicable to the underlying securities markets and new antifraud rules unique to security-based swaps under the re-proposed Rule, which will have the presumably unintended effect of discouraging market participants from trading in both markets simultaneously. This outcome was certainly not intended by Congress, which explicitly and clearly limited Section 9(j) to actions connected with the purchase and sale of security-based swaps, and is contrary to the nature of the markets, which are designed for coordinated trading between securities and security-based swaps. Accordingly, we

[21] 15 U.S.C. 78i(j) (emphasis added).

respectfully urge the Commission to modify the re-proposed Rule by providing that its prohibitions do not extend to the purchase or sale of underlying securities.

Moreover, we note that the Proposal will place market participants in this untenable position not on a periodic basis, but potentially on a daily basis throughout the term of each security-based swap transaction. In particular, certain performance obligations, such as margin payments, are often required as frequently as daily.[22] Under such circumstances, parties will then be required to assess their status under re-proposed Rule 9j-1 on each business day and determine if they are able to comply with preexisting contractual commitments. This is a completely unworkable situation to which market participants will have no viable alternatives, other than refraining from entering into transactions that traders, investment advisers and others would otherwise regard as prudent and necessary for the accounts under their management.

In addition, because certain types of security-based swaps, particularly credit default swaps ("**CDS**"), are used to hedge against exposure to a particular reference entity, the breadth of the Proposal will impose unworkable constraints on market participants in other respects as well. For example, a large holder of debt securities may enter into a CDS with respect to the issuer of the debt, as the reference entity, in order to hedge its risk. In order to protect against potential liability under re-proposed Rule 9j-1, the holder might refrain from taking actions that are advisable or necessary in order to protect its debt position, such as taking part in restructuring negotiations with the issuer, which could result in the receipt of MNPI, despite the fact that refraining from such action could have material adverse consequences. Indeed, we expect that many debt investors that maintain security-based swap positions for hedging purposes would refrain from negotiating with issuers or loan syndicate members entirely in order to avoid an action that could be seen as inappropriate by the Commission.[23] This places not only corporate entities but also funds, asset managers and their clients in serious jeopardy on an ongoing basis, with major implications for the security-based swap and underlying securities markets. We anticipate that some market participants will refrain from transacting in security-based swaps altogether, thereby severely limiting liquidity.

To avoid these extensive and material adverse consequences, and to better align re-proposed Rule 9j-1 within the scope of authority designated by Congress under Section 9(j) and the applicable definitions of "purchase" and "sale," as amended under the Dodd-Frank Act, we respectfully urge the Commission to modify the re-proposed Rule by eliminating interim actions or omissions arising from contractual obligations under a security-based swap agreement.

---

[22] *See, e.g.*, 17 C.F.R. 240.18a-3.

[23] As discussed in Part VI, this concern applies to both re-proposed Rule 9j-1(a) and proposed Rule 9j-1(b). To avoid this result, which would have a chilling effect on commercial lending markets, the Commission should revisit both aspects of the rule in light of feedback provided in this letter and by other market participants.

## III. The proposed safe harbors are overly restrictive and not sufficiently clear, and do not adequately protect from liability market participants engaged in good-faith performance of their obligations under security-based swap agreements.

We appreciate the Commission's inclusion in the Proposal of two safe harbors to re-proposed Rule 9j-1, which were not included in the Original Proposal, and which the Commission notes were introduced partially in response to concerns we raised in our 2010 Comment Letter.[24] The first safe harbor would exempt from liability persons who take actions in accordance with binding contractual rights and obligations under a security-based swap while in possession of MNPI.[25] The second safe harbor exempts from liability security-based swap transactions that are effected pursuant to a bilateral portfolio compression exercise or a multilateral portfolio compression exercise.[26] We note initially, however, that the fact that the Commission included these safe harbors only serves to underscore the problematic scope of re-proposed Rule 9j-1. If the Proposal had been framed appropriately, and within the Commission's authority, no safe harbors would have been necessary.

In any event, we do not believe that the proposed safe harbors, as written, adequately address our concerns with respect to the scope of re-proposed Rule 9j-1, or that they will serve to alleviate the adverse consequences described above. Specifically, we respectfully submit that the safe harbors are overly narrow, that they are not adequately designed to address the problems with the Proposal, and that they will ultimately result in greater uncertainty as to the type of conduct in connection with a security-based swap agreement that would be considered a violation of re-proposed Rule 9j-1.

---

[24] Proposal, at p. 6660, 6662.

[25] Proposed Rule 240.9j-1(f)(1). The proposed safe harbor provides that: "(f) A person shall not be liable under paragraph (a) of this section solely for reason of being aware of material non-public information while taking the following actions: (1) Actions taken by a person in accordance with binding contractual rights and obligations under a security-based swap (as reflected in the written security-based swap documentation governing such transaction or any amendment thereto) so long as: (i) The security-based swap was entered into, or the amendment was made, before the person came into possession of such material non-public information; and (ii) The entry into, and the terms of, the security-based swap are themselves not a violation of any provision of this section."

[26] Proposed Rule 240.9j-1(f)(2). The proposed safe harbor provides that: "(f) A person shall not be liable under paragraph (a) of this section solely for reason of being aware of material nonpublic information while taking the following actions: … (2) Security-based swap transactions effected by a person pursuant to a bilateral portfolio compression exercise (as defined in § 240.15Fi-1(a)) or a multilateral portfolio compression exercise (as defined in § 240.15Fi-1(j)) so long as: (i) Any such transactions are consistent with all of the terms of a bilateral portfolio compression exercise or multilateral portfolio compression exercise, including as it relates to, without limitation, the transactions to be included in the exercise, the risk tolerances of the persons participating in the exercise, and the methodology used in the exercise; and (ii) All such terms were agreed to by all participants of the bilateral portfolio compression exercise or multilateral portfolio compression exercise prior to the commencement of the applicable exercise."

The first proposed safe harbor is limited to actions that are (1) taken "in accordance with binding contractual rights and obligations under a security-based swap (as reflected in the written security-based swap documentation governing such transaction or any amendment thereto)"[27] and (2) where "the security-based swap was entered into, or the amendment was made, before the person came into possession of such material nonpublic information."[28] By limiting the scope of the safe harbor to "binding contractual" rights and obligations, and the written agreement between the parties, however, the Commission has restricted the potential applicability of this safe harbor in ways that will materially limit its utility. Parties' determinations of their contractual obligations often involve interpretations of the terms or further discussions and informal resolutions between the parties. Indeed, ongoing communications between counterparties is characteristic of security-based swap transactions. It might not be clear in all instances if the resulting actions are taken pursuant to "binding contractual rights and obligations" or whether informal interpretations and resolutions might constitute "amendments." Further, the status of mutually agreed-upon early terminations of security-based swaps remains uncertain under this provision. Because performance under a security-based swap often involves, and even requires, communications between the parties, the scope of this safe harbor is unclear, and could inhibit a security-based swap counterparty from enforcing or performing ordinary-course interim obligations in good faith, or conducting necessary communications with its counterparties during the term of a security-based swap.

We recognize the challenges faced by the Commission in formulating a safe harbor that exempts good-faith, ordinary-course-of-business actions that allow counterparties to enforce or perform interim obligations under a security-based swap agreement, while ensuring that Rule 9j-1 deters fraudulent and manipulative behavior in the security-based swaps markets. This challenge reinforces why it is necessary for the definition of "purchase and sale" to exclude ongoing payments, deliveries, and other obligations in the context of security-based swap agreements, as discussed further in Part II above, and to reflect the scope of the Commission's authority under Section 9(j).

## IV. Re-Proposed Rules 9j-1(a)(3) and (4) should include a scienter standard to account for the unique aspects of security-based swap transactions.

We are concerned that, under the Proposal, a scienter standard would apply only to alleged violations of re-proposed Rules 9j-1(a)(1) and (2).[29] In contrast, re-proposed

[27] Proposed Rule 240.9j-1(f)(1).

[28] Proposed Rule 240.9j-1(f)(1)(i).

[29] Proposal, at p. 6659. Re-proposed Rule 240.9j-1(a)(1) applies where a person "employs or attempts to employ any device, scheme, or artifice to defraud or manipulate." Re-proposed Rule 240.9j-1(a)(2) applies where a person "makes or attempts to make any untrue statement of a material fact, or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Scienter requires a "mental state embracing intent to deceive, manipulate or defraud." *See Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 193 (1976); Proposal, at p. 6659, n.67.

Rules 9j-1(a)(3) and (4) would not require scienter and would impose liability in situations where a person:

> (3) obtains or attempts to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
>
> (4) engages or attempts to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.[30]

In these circumstances, liability could extend to conduct that is merely negligent or inadvertent, without requiring any intent by the party to mislead or defraud. The Proposal notes that the different intent standards are intended to mirror the standards applicable to violations of Sections 17(a)(2) and (3) of the Securities Act.[31] While the language of re-proposed Rule 9j-1(a)(3) and (4) may mirror that of Section 17(a)(2) and (3) of the Securities Act, these rules would apply in different contexts and with respect to different types of transactions and counterparties. We respectfully submit that the application of the same standard to these disparate situations is unwarranted and will result in liability being imposed inappropriately on persons who have not engaged in fraud. Given the differences between the type of conduct that is subject to liability under the Proposal and the nature of the relationship between security-based swap counterparties, we recommend that all liability under the re-proposed Rule 9j-1 be subject to a scienter standard.

In particular, we note that the scope of conduct that could give rise to liability in the context of re-proposed Rule 9j-1 is potentially broader than Sections 17(a)(2) and (3) of the Securities Act, which underscores why the re-proposed Rule should include an intent standard. As proposed, liability under re-proposed Rules 9j-1(a)(3) and (4) applies to *attempted* conduct, whereas liability under Sections 17(a)(2) and (3) of the Securities Act does not. Further, liability under Sections 17(a)(2) and (3) of the Securities Act arises only in the context of an "offer or sale of any securities,"[32] while, as discussed in Part II above, the Commission has proposed an overly broad interpretation of "purchase and sale," with respect to re-proposed Rule 9j-1, that also applies to parties' performance of interim obligations under security-based swap transactions. In the event that the Commission maintains this broad interpretation, any liability for interim actions taken during the term of a security-based swap should be subject to a scienter standard. Otherwise, parties to security-based swaps will be exposed to potential liability each time they perform their agreed-upon contractual obligations (including daily margin payments) and will be required to conduct complex and burdensome reviews in connection with each aspect of performance, which

---

[30] Re-Proposed Rule 240.9j-1(a)(3),(4). *See also* Proposal, at p. 6659.

[31] Proposal, at p. 6659; 15 U.S.C. 77q(a)(2),(3).

[32] 15 U.S.C. 77q(a).

will be unworkable. As such, rather than providing counterparties with additional protections, the proposed negligence standard would serve to chill the security-based swap market, harm security-based swap counterparties and others who depend on the security-based swap markets for hedging and financing and ultimately result in less liquid and effective security-based swap markets.

We also note that Sections 17(a)(2) and (3) frequently applies to impersonal transactions where there is no relationship between the purchaser and the seller. The purchaser of a security in such a transaction may have no contact with, knowledge of or privity of contract with the seller. In the context of these types of transactions, there may be a stronger basis for imposing liability without scienter, at least in certain circumstances, since one party cannot form a specific intent to defraud an anonymous third party with which it has no contact or relationship. The same considerations are not applicable, and the same standards are not appropriate, with respect to re-proposed Rules 9j-1(a)(3) and (4), which are applicable only to security-based swap transactions. Security-based swap transactions are typically bilateral transactions between disclosed, sophisticated counterparties who deal directly with each other. Because of the nature of and relationship between the parties, and the extent of the negotiations that typically occur, counterparties are able to (and do) allocate risk and liability between themselves pursuant to the terms of the security-based swap contract. Moreover, given the sophistication and experience of market participants, they are able to identify instances in which they require additional information or disclosures and are able to (and do) request their counterparties to provide whatever is needed. Sophisticated counterparties dealing directly with each other on negotiated terms, therefore, should not be subject to liability in connection with actions undertaken under a bilateral contract without an intent to defraud or manipulate.

Lastly, we want to emphasize that, as noted in the Proposal, security-based swap counterparties remain subject to the lower negligence standard for each sale of a security under Sections 17(a)(2) and (3), which apply equally to security-based swaps.[33] Accordingly, requiring a scienter standard for liability under re-proposed Rule 9j-1(a)(3) and (4) would not lessen the current standard of liability applicable to security-based swap transactions. Rather, it would impose a more appropriate standard given the type of conduct that re-proposed Rule 9j-1 is attempting to address.

## V. The Commission should extend the types of affirmative defenses that are available under Rule 10b5-1 to apply to re-proposed Rule 9j-1.

As a general matter, the Proposal fails to take into account the fact that most firms active in the security-based swap markets have established and enforce robust internal information barriers that separate the "private" side of a firm's trading business, which has access to MNPI and, therefore, is subject to trading restrictions, from the "public" side, which does not have access to MNPI and is not so restricted. As drafted, the Proposal could unnecessarily and substantially

[33] *See* 15 U.S.C. 77q. This further reinforces that re-proposed Rule 9j-1 is not merely replicating existing antifraud rules to security-based swap markets. Instead, it is imposing additional liability that should be tailored to the specifics of security-based swap markets.

restrict activity—even by those trading desks that do not have access to MNPI—because other desks at the same firm may have such information. At a minimum, the Commission should recognize the existence and utility of information barriers in the context of the Proposal and provide a safe harbor for trading in security-based swaps by those parts of a business that do not have access to MNPI.

Specifically, in addition to clarifying that "purchase and sale" excludes interim obligations, we believe the Commission should also extend the Rule 10b5-1 affirmative defenses[34] to apply to re-proposed Rule 9j-1, along with the proposed safe harbors, in order to be consistent with other securities laws antifraud provisions. As noted in the Proposal, security-based swaps are also within the definition of "securities" under the Exchange Act and are therefore subject to those provisions of the Exchange Act and SEC regulations applicable to securities generally.[35] More specifically, as the Commission has also noted, security-based swap transactions are subject to SEC Rule 10b-5, the principal regulatory antifraud provision.[36] However, Rule 10b5-1, in contrast to re-proposed Rule 9j-1, provides for a number of affirmative defenses to alleged Rule 10b-5 violations.[37] The Commission should clarify that these affirmative defenses are available in the

[34] *See* 17 C.F.R. 240.10b5-1.

[35] Proposal, at pp. 6660, 6666.

[36] *Id*.

[37] 17 C.F.R. 240.10b5-1. SEC Rule 10b5-1(c) states that:

(1) (i) Subject to paragraph (c)(1)(ii) of this section, 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.

context of security-based swaps, and specifically as a defense to any alleged violation of re-proposed Rule 9j-1.

Rule 10b5-1(c) affirmative defenses generally provide that a purchase or sale is not "on the basis" of MNPI if the person can establish that the person with access to MNPI has no influence, or discretion, over the purchase or sale or the manner in which it takes place. Of particular note, Rule 10b5-1(c)(2) provides that a non-natural person may demonstrate that a purchase or sale of securities is not on the basis of MNPI if (1) the individual making the investment decision was not aware of the information; and (2) the person had implemented reasonable policies and procedures to ensure that individuals making investment decisions would not violate laws prohibiting trading on the basis of MNPI.[38]

Rule 10b5-1(c), and specifically Rule 10b5-1(c)(2), affirmative defenses are particularly important for large organizations with multiple business units that may be involved in security-based swap transactions. If the Commission does not extend Rule 10b5-1(c) affirmative defenses to security-based swap transactions, organizations could be required to establish systems for sharing information between previously separated business units to ensure that no trading is conducted (or actions taken under an existing contract) while in possession of MNPI. Given the ongoing nature of security-based swap agreements and the broad scope of the Proposal, this information sharing would be required on a near-continuous basis and could severely inhibit the ordinary-course functioning of key players in the security-based swap markets. Not only would this result in significant operational challenges, but it would also jeopardize the ability of market

---

(ii) Paragraph (c)(1)(i) of this section is applicable only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section.

(iii) This paragraph (c)(1)(iii) defines certain terms as used in paragraph (c) of this Section.
(A) **Amount**. "Amount" means either a specified number of shares or other securities or a specified dollar value of securities.
(B) **Price**. "Price" means the market price on a particular date or a limit price, or a particular dollar price.
(C) **Date**. "Date" means, in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). "Date" means, in the case of a limit order, a day of the year on which the limit order is in force.

(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.

[38] 17 C.F.R. 240.10b5-1(c)(2).

participants to rely on other safe harbors that require information barriers. For example, the sharing of MNPI inside a firm for the purposes of avoiding liability under re-proposed Rule 9j-1 may exclude the organization from existing Rule 10b5-1 affirmative defenses. Similarly, certain beneficial ownership reporting requirements that permit position disaggregation across independent business units[39] may also be unavailable in the event that information barriers are circumvented in order to avoid liability under re-proposed Rule 9j-1.

Rather than removing well-established information barriers between independent business units, it is more likely that these organizations would limit their trading in security-based swaps in order to mitigate the potential collateral consequences. The result would be reduced liquidity, increased volatility and greater difficulty for market participants to access the security-based swap markets for bona fide reasons.

To avoid these unintended consequences, we recommend that the Commission clarifies that Rule 10b5-1 affirmative defenses apply equally to security-based swap transactions and protect against any potential liability under re-proposed Rule 9j-1. This approach would further the Commission's goal of addressing manufactured or other opportunistic strategies involving fraudulent, deceptive, or manipulative activity without discouraging participation in security-based swap markets or preventing counterparties from engaging in ordinary-course interim actions under existing agreements.[40] It would also support and enhance the types of separations between business units that are already in place for these and other purposes.

## VI. The scope of proposed Rule 9j-1(b) is overly broad and will have a chilling effect on the security-based swap markets and the markets for the underlying securities.

Proposed Rule 9j-1(b) includes a broad prohibition that would make it unlawful for any person to "directly or indirectly, manipulate or attempt to manipulate the price or valuation of any security-based swap or any payment or delivery related thereto."[41] The Proposal suggests that the purpose of proposed Rule 9j-1(b) is to prevent manufactured and other opportunistic strategies in CDS markets, such as actions that improperly cause or avoid payments under a CDS.[42] We understand the Commission's concern and the reasons for a rule that prohibits certain of the manufactured credit events that are described in the Proposal. However, in its current form, proposed Rule 9j-1(b) is overly broad and will potentially apply to a broad range of ordinary course

---

39 *See, e.g.*, *Amendments to Beneficial Ownership Reporting Requirements*, Exchange Act Release No. 34-39538 (January 12, 1998), 63 Fed. Reg. 2854, 2857-2858 (January 16, 1998).

40 Proposal, at p. 6656. The Commission notes that it is seeking comments on how it can "address manufactured or other opportunistic strategies that involve fraudulent, deceptive, or manipulative activity, or that involve such quotations as are fictitious, without impairing the proper functioning of security-based swap markets or other securities markets."

41 Proposed Rule 240.9j-1(b).

42 Proposal, at p. 6663.

actions in the security-based swap and underlying securities markets that are not manipulative and need not be prohibited.

While the Commission appears to recognize this risk,[43] the text of the rule and the Commission's discussion of it in the Proposal does little to address these concerns. For example, the Commission notes that the proposed Rule is "designed to capture situations when a payment under the security-based swap is *intentionally distorted*"[44] and that the Commission expects to use its judgment to bring enforcement actions "when a party takes action for the purposes of avoiding or causing, or increasing or decreasing, a payment under a security-based swap in a *manner that would not have occurred, but for such actions*."[45] The language regarding intent and willful conduct is helpful, but of course does not appear in the language of the proposed Rule itself. Moreover, the underscored language at the conclusion of this statement, regarding whether an outcome would have occurred "but for such actions," is vague, subjective and ultimately unworkable for market participants. It also requires an ability to foresee the nature and cause of events that have not yet occurred, because a market participant cannot know in advance all of the effects of its actions and those of others, thereby rendering this limitation virtually useless. Further, the Commission's articulated standard appears to capture the very ordinary course business events that the Commission purports to exclude. For example, the Proposal specifically recognizes that

> reference entities often rely on financing and other forms of relief to avoid defaulting on their debt, and the proposed rule is not intended to discourage lenders and prospective lenders from discussing or providing such financing or relief, even when those persons also hold CDS positions.[46]

We agree that this type of activity should not be captured by the proposed Rule. Unfortunately, however, it falls squarely within the rule text proposed by the Commission. Financing under this scenario is clearly a payment at least indirectly "related to" a security-based swap and would, therefore, be captured by the rule. Practically any financing extended to a reference entity, particularly those entities experiencing financial difficulty, could be alleged to have the effect of "avoiding or causing, or increasing or decreasing"[47] payments under CDS contracts or equity total return swaps. While we appreciate that the Commission does not intend to restrict the availability of financing for U.S. businesses, we note that the Commission has provided no meaningful standards for distinguishing appropriate financing activities from those

---

[43] For example, the Commission notes that it "does not intend for re-proposed Rule 9j-1(b) to apply to taking affirmative actions in the ordinary course of a security-based swap transaction or the underlying referenced security." *See* Proposal, at p. 6663.

[44] *Id*. (emphasis in original).

[45] *Id*. (emphasis added).

[46] *Id*.

[47] *Id*.

that may be in violation of proposed Rule 9j-1(b), and we respectfully submit that the rule text must be amended to match the Commission's purported intent.[48] If the proposed Rule is not changed, we believe that market participants will reduce their lending activity as well as their security-based swap and securities market activity, or avoid certain markets altogether. This will inevitably result in reduced liquidity and diminished utility of such markets.

In addition, the proposed Rule will likely impede or prevent a number of other activities that the Commission typically encourages. For example, creditors who hold CDS and/or securities of an issuer may hesitate to engage with the issuer or other creditors (*e.g.*, as members of a creditors' committee) as they currently do in the ordinary course, which could negatively impact efforts to manage potential default scenarios in a coordinated and constructive manner. Moreover, we note that participants in these markets are sophisticated investors that are well-positioned to monitor and protect against manipulative conduct through negotiation and interaction with market groups.[49]

Moreover, ordinary course financing transactions are only one of a multitude of routine business activities that could be jeopardized under the Proposal. For example, public debt investors will frequently negotiate with an issuer (for example, in the context of an auction settlement) to make a debt instrument available so that it can be deliverable under a CDS contract. Despite the fact that this action is standard and necessary to maintaining liquidity in security-based swap and debt markets, it could impact the price of a CDS, and therefore subject the market participant to potential liability under proposed Rule 9j-1(b). Similarly, in equity markets, active investors with portfolios that are comprised of equity securities and total return swaps often engage with an issuer's management to recommend strategic or governance improvements. In recent years, this has been an effective tool for shareholders to pursue environmental, social and governance ("**ESG**") improvements within issuers. Under the proposed Rule, if an activist investor has a security-based swap position in a particular reference entity, it could potentially be liable under proposed Rule 9j-1(b) for working with management to encourage or facilitate ESG initiatives that increase the value of the issuer, which would in turn impact the price of a total return swap.

All of these issues arise as a result of the fact that neither the Proposal nor proposed Rule 9j-1(b) provides clear guidance on what would be considered manipulative conduct. As noted above, the Commission's broad description of actions that "intentionally distort" payments or the

---

[48] The Commission also notes that it intends to limit its enforcement activity under the proposed Rule to "actions taken outside the ordinary course of a typical lender-borrower relationship" based on the "facts and circumstances of a particular situation." Proposal, at p. 6663. While we appreciate the Commission's intent, market participants must rely on the plain meaning of the rule text and cannot necessarily take comfort in a non-binding statement of intention.

[49] *See, e.g.*, International Swaps and Derivatives Association, *2019 Narrowly Tailored Credit Event Supplement to the 2014 ISDA Credit Derivatives Definitions* (July 15, 2019), available at https://www.isda.org/book/2019-narrowly-tailored-credit-event-supplement-to-the-2014-isda-credit-derivatives-definitions/.

price of a security in a "manner that would not have occurred but for such actions" does not provide market participants with clarity as to what is considered manipulative behavior. In response, market participants are likely to avoid engaging in ordinary course activities, including those described above, to avoid potential regulatory scrutiny. By contrast, we note that the CFTC's anti-manipulation rules applicable to swap transactions, which are similar and analogous to security-based swaps in many respects, set out a much clearer standard regarding manipulative conduct.[50] We respectfully request that the Commission to take a similar approach to proposed Rule 9j-1(b) by more clearly defining what types of actions would be considered manipulative.

We recommend that the Commission revisit proposed Rule 9j-1(b) and appropriately tailor it to address the Commission's core concerns, without implicating other non-manipulative actions taken by market participants. In doing so, the Commission should re-release proposed Rule 9j-1(b) for public comment along with a specific description of what constitutes manipulative conduct so as to provide market participants the ability to adequately assess the potential impact of the Proposal on the security-based swap markets.

* * *

We appreciate the opportunity to provide our comments to the Commission regarding the re-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 Joseph Schwartz, Director and Counsel, or the undersigned at (202) 730-2600.

Respectfully submitted,

/s/ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Regulatory Affairs
Managed Funds Association

cc: The Hon. Gary Gensler, SEC Chairman
The Hon. Hester M. Peirce, SEC Commissioner
The Hon. Allison Herren Lee, SEC Commissioner
The Hon. Caroline A. Crenshaw, SEC Commissioner
Mr. Haoxiang Zhu, Director, Division of Trading and Markets

[50] *See Prohibition on the Employment, or Attempted Employment, of Manipulative and Deceptive Devices and Prohibition on Price Manipulation*, 76 Fed. Reg. 41398, 41407 (July 14, 2011). Specifically, the CFTC more clearly articulated a specific set of criteria that must be satisfied in order to establish a violation of the anti-manipulation rules.

# APPENDIX A

## MFA Comment Letter dated December 23, 2010

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]

---

[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]
>
> [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]
>
> 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

---

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

---

[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.

---

[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

---

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]

---

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

---

[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.

*****

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

# APPENDIX B

## MFA Comment Letter dated March 29, 2011

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

March 29, 2011

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] thanks the Securities and Exchange Commission (the "Commission" or the "SEC") for the continued opportunity to provide comments on proposed Rule 9j-1 ("Rule 9j-1") under the Securities Exchange Act of 1934 (the "Exchange Act"). The proposed rule is intended to prevent fraud, manipulation, and deception in the security-based swaps markets. This letter addresses some of the issues that we discussed in our conference call with the Commission Staff on March 2, 2011. It also supplements our earlier comment letter.[2]

Our letter is structured as follows. We first address several preliminary points, such as the exceptional importance of properly drafting an anti-fraud rule for the security-based swaps market. We support the objectives of the proposed rule but are concerned about the harms to the market likely to result from its ambiguities. We then discuss an approach to defining the purchase and sale of security-based swaps that is consistent with the authorizing legislation and the way swaps are actually traded on the market in practice. Finally, we offer a few thoughts on the cost-benefit analysis of the rule. We hope to work with the Commission in designing an anti-fraud rule that achieves Congress's goal in enacting Section 763(g) of the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and is appropriate to the needs of the security-based swaps 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 $1.9 trillion invested in absolute return strategies. MFA is headquartered in Washington, DC, with an office in New York.

[2] *See* letter from Stuart J. Kaswell, Executive Vice President and Managing Director, General Counsel, MFA to Ms. Elizabeth M. Murphy, Secretary, SEC, December 23, 2010, File No. S7-32-10, available at http://www managedfunds.org/downloads/MFA%20Final%20Comment%20Letter %20on%20SEC%20Proposed%20Rule%209j-1.pdf.

## I. The Importance of the Security-Based Swaps Market and Honest Markets and the Ambiguities Created by Proposed Rule 9j-1.

We want to begin by emphasizing that much is at stake with proposed Rule 9j-1. MFA and its members oppose fraudulent and manipulative activities in the financial markets. MFA members rely on honest markets in securities, securities-based swaps, and other financial instruments, but crafting an anti-fraud regulation specifically for the security-based swaps markets requires extreme care. If not done properly, that is, to proscribe true misconduct without interfering with or inhibiting legitimate market activity, the consequences could be enormously harmful and costly for the securities markets and investors.

The U.S. OTC derivatives markets have grown in size and importance during the past decade and provide substantial efficiencies to the capital markets and the economy. These markets developed through compliance with existing anti-fraud provisions in the federal securities laws. Policymakers have identified issues with the derivatives markets and adopted a variety of reforms in the Dodd-Frank Act, such as Titles I, II, VII, and VIII, to address the issues, but they did not cite concerns with fraud or manipulation. Congress clearly sought to establish a regulatory framework that would allow the derivatives markets to perform its important economic functions and not to hamstring the markets.

A misstep in drafting a swaps anti-fraud rule could disrupt and curtail major segments of the OTC derivatives markets, and that is our concern with proposed Rule 9j-1. The current proposed rule would interfere unduly with legitimate market activity, diminish the economic benefits of the swaps markets, and harm them. Aspects of the proposed rule would interject great uncertainty and unpredictability into the security-based swaps markets and reduce the willingness of law-abiding firms to trade. We provide several examples below, and comment letters from other knowledgeable market participants give other examples.[3] The result, in our view, is that the rule would likely deter a significant volume of legitimate market participation. Investors would reduce their use of swaps, and credit markets would be less liquid and possibly freeze, depriving the securities markets of the substantial benefits provided by swaps.

We think it is possible for the Commission to adopt an anti-fraud rule that proscribes truly fraudulent behavior while avoiding these pitfalls. MFA has consistently supported measures that would deter fraud and manipulation and foster honest and vibrant financial markets. As we discuss below, an anti-fraud regulation for the security-based swaps markets can fit the characteristics and specific needs of these markets and could benefit rather than harm the markets by applying the definitions of "purchase" and "sale" of a security-based swap more in line with the statutory definitions and the practice in the swaps markets.

## II. The Statutory Authorization for a Security-Based Swap Anti-Fraud Rule.

The Commission proposed Rule 9j-1 pursuant to Section 763(g) the Dodd-Frank Act. Section 763(g) enacted the following prohibition and granted the Commission rulemaking authority in association with it: "It shall be unlawful for any person ... to effect any transaction

[3] *See* letter from Kenneth E. Bentsen, Jr., Executive Vice President, Securities Industry and Financial Markets Association and Robert G. Pickel, Executive Director and Chief Executive Officer, International Swaps and Derivatives Association, Inc., to Elizabeth M. Murphy, Secretary, SEC, December 23, 2010, File No. S7-32-10; and letter from R. Bram Smith, Executive Director, The Loan Syndications & Trading Association, to Elizabeth M. Murphy, Secretary, SEC, December 23, 2010, File No. S7-32-10.

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 ....”[4]

The Dodd-Frank Act and an earlier provision in the Exchange Act define “purchase or sale” of a security-based swap as the “[e]xecution, 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, as the context may require.”[5] The last clause is important because it directs regulators to consider the context in which their rules will apply.

III. Purchases or Sales of Security-Based Swaps.

We suggest that a final Rule 9j-1 should apply the statutory purchase and sale definitions in a straightforward way that is consistent with market practice and appropriate to the context in which these instruments are structured and traded. Swaps are not simply “bought and sold” over the counter or on an exchange like most securities. They are bilateral contracts and, as such, “trade” through novations, unwinds, and assignments. Viewed in that light, each word in the definitions of “purchase or sale” serves a purpose.

“*Execution,*” in the context of a security-based swap, is the equivalent of a “purchase” of the swap by both parties to the agreement. “Execution” means the entry into a security-based swap agreement by the counterparties that specifies the terms of the security-based swap. Unlike a traditional securities transaction, there are, in effect, two buyers rather than one buyer and one seller.

“*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,*” in the context of a security-based swap, is the equivalent of a “sale” of the swap. In our view, this provision refers to a new agreement by the parties to the security-based swap to end or otherwise eliminate exposure under the existing swap agreement before its scheduled maturity or in a manner not contemplated by the swap agreement as originally executed.

Security-based swaps are generally terminated in this manner in one of two ways. Total return swaps are generally terminated through an “unwind” – an agreement by the two parties to the transaction to terminate the swap at an agreed-on price before the scheduled termination date of the swap. In that circumstance, there has been a “*termination*” or “*extinguishment of rights or obligations under*” the total return swap, and both parties to the transaction have effectively “sold” the swap position.

Credit default swaps are generally terminated through a novation agreement, pursuant to which the original swap is replaced with a new swap between a third party and one of the original swap counterparties, at an agreed price. The other original swap counterparty (the “transferor”) is not a party to the new swap transaction. In that circumstance, there has been an “*assignment, exchange or similar transfer or conveyance of*” the original credit default swap, and the transferor has effectively “sold” the swap position. Credit default swaps may also be terminated through an “unwind” agreed between the two parties to the transaction.

---

[4] 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).

[5] *See* Dodd-Frank Act § 761(a).

Accordingly, we believe that Section 763(g) of Dodd-Frank is aimed at preventing fraudulent, deceptive, or manipulative acts in connection with: (i) the entry into a securities-based swap; (ii) the novation or assignment of a securities-based swap; and (iii) the "unwind" of a securities-based swap. These actions are all the equivalent of a purchase or sale and are appropriately subject to anti-fraud regulation. Over time, actual practices in the market may demonstrate that an anti-fraud rule need not apply when these actions do not cause a party to change its economic exposure.

## IV. Settlements of Security-Based Swaps that are not Purchases or Sales.

Security-based swaps also terminate or settle in a variety of other circumstances that are contemplated by the terms of the contract itself. These types of terminations or settlements are not the equivalent of a purchase or sale and thus should not be subject to regulation pursuant to a final Rule 9j-1. The easiest example of this type of termination is the expiration of a securities-based swap at maturity. The expiration of a swap is clearly not a purchase or sale within the meaning of the Dodd-Frank Act: the definition of purchase and sale only covers terminations that occur "prior to [a swap's] scheduled maturity date."

Similarly, the settlement or termination of a swap as a result of an event specified in the swap agreement does not result in the "extinguishment of rights or obligations" under the swap or otherwise constitute a "purchase or sale." Examples of these types of events would include, without limitation:

(A) Credit events related to the reference obligation.

(B) Corporate actions. For example, in a total return swap, the swap may be terminated early if the issuer of the underlying shares merges with another company and the underlying shares no longer exist.

(C) Disruption events. For example, in a total return swap, a party may have the right to terminate a swap early if it loses its ability to hedge the transaction or if, as a result of a change in law, it becomes materially more expensive for the party to maintain the transaction.

(D) Counterparty defaults or termination events. For example, a counterparty to the swap becomes bankrupt, fails to make payments in accordance with the terms of the agreement, or otherwise materially breaches the agreement, makes a misrepresentation, or fails to comply with the credit terms specified in the agreement.[6]

In each of these instances, the settlement and termination of the swap triggered by the relevant event results in the full satisfaction of the parties' rights and obligations in accordance with and in the manner contemplated by the swap agreement from the very beginning of the transaction. Moreover, in each of these instances, it would be highly disruptive to the swap markets and, particularly in the case of a counterparty default, could pose systemic risk if Rule 9j-

[6] In addition, swaps require the parties to perform many obligations during the life of the agreement that do not result in the termination or settlement of the swap contract. Such obligations include the requirement to post collateral or make interim payments (such as premium payments on credit default swaps or interest and spread payments on total return swaps). The performance of these obligations in accordance with the pre-agreed terms of the contract also would not constitute a "purchase" or "sale" of the securities-based swap.

1 or uncertainty about its application prohibited a party to a security-based swap from terminating or settling the transaction. We now explain this concern with the current proposal by discussing credit events and counterparty defaults more fully, but a similar explanation and examples exist for corporate actions and disruption events.

*Credit Events*. If a party to a credit default swap came into possession of material non-public information after the execution of a credit default swap, proposed Rule 9j-1 would prohibit the party from delivering securities or making relevant payments to settle the swap, notwithstanding that the existing swap agreement specified the performance of such obligations. As a result, the party would be forced to breach the agreement with its counterparty. This, in turn, would give its counterparty the right to terminate every transaction under the governing documentation (for example, an ISDA Master Agreement or clearing agreement) between the two parties, including transactions as to which the swap party did not possess material non-public information.

Even if the counterparty did not elect to terminate, the counterparty might well have hedged its exposure to the credit default swap (or might have been using the credit default swap as a hedge for some other position). In that case, the counterparty would be left unhedged and would potentially be required to make corresponding payments on a hedge transaction to a third party without receiving payment from the original swap party. Faced with the uncertainty of knowing if or when a counterparty to a swap transaction might be prohibited from performing its obligations (and thus deprive its counterparty of the benefits that the counterparty had bargained for in entering the swap transaction), many market participants would simply be unwilling to transact in security-based swaps.

*Counterparty Defaults*. Proposed Rule 9j-1 would create similar difficulties for a party to a swap that faces a counterparty default. The concern here is with the creditworthiness of the other party to the swap agreement and not with a credit event related to the underlying reference entity or obligation. If the party came into possession of material non-public information about the reference entity after the execution of the swap and its counterparty then defaulted, Rule 9j-1 as currently written would not permit the party to obtain an early termination of the swap, even though swap agreements generally state that a party may terminate when a counterparty defaults. The swap party would be forced to continue facing economic exposure to a non-performing counterparty – potentially even a counterparty in bankruptcy proceedings. Moreover, because derivatives contracts are generally entered pursuant to master agreements that prohibit a non-defaulting party from terminating fewer than all transactions covered by the master agreement, the party in possession of material non-public information about a single reference entity in a single swap contract would be unable to terminate any of the transactions under the master agreement.

Prohibiting a party from terminating its swap positions on a counterparty default would not advance any policy against fraud or market manipulation. The party would be terminating because of an event explicitly described in the swap agreement (the lack of creditworthiness of its counterparty).

In addition, such a prohibition would run contrary to other strong policies, repeatedly recognized by Congress, in promoting the efficient functioning of the swaps and derivatives markets. Congress has acted to protect this important market by enacting provisions in the Bankruptcy Code to allow a swap party to enforce its contractual rights in the event a counterparty becomes bankrupt. It has thus enacted a safe harbor from the automatic stay provisions, providing, in the broadest possible terms, that the "exercise of any contractual right … to cause the liquidation, termination, or acceleration" of a swap agreement because of the debtor's

bankruptcy "shall not be stayed, avoided, or otherwise limited by operation of any provision" of the Bankruptcy Code.[7]

Congress did not alter this provision in the Dodd-Frank Act when it carefully considered other provisions for the derivatives market. Accordingly, as a policy matter and consistent with Congressional policies in the Bankruptcy Code, a swaps anti-fraud rule should not interpret the language "*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*" to mean that a swap party would be prohibited from terminating a security-based swap on a counterparty default pursuant to a right in the swap agreement because that party has material confidential information about a reference entity or obligation when the counterparty defaults.

## V. Proposed Definition of Sale.

As we have outlined above, security-based swaps may be terminated in a variety of ways. Some are functionally equivalent to a "sale," but many are not. Based on the practices and conventions in the security-based swaps market, we believe that the appropriate way to define the reach of a rule under Section 9(j) of the Dodd-Frank Act is to define a sale in the following way. A termination is a sale when a party acts to discharge all its further obligations under a swap contract with a new contract, such as by novation, assignment, or unwind, but a sale does not occur when a party discharges all its obligations by performance in accordance with the terms of the existing swap contract.

## VI. Considerations for the Cost-Benefit Analysis.

Some of the comments above and submissions in other comment letters bear directly on the costs and benefits of the proposed anti-fraud rule. The proposing release contained a preliminary cost-benefit analysis and requested comment on it.[8] The proposing release identified several possible benefits, saying that, by guarding against misconduct that interferes with the proper functioning of the markets, the proposed rule would "help to promote price efficiency, the integrity of the price discovery process, and fair dealing between market participants in connection with security-based swaps." The proposing release did not identify any costs: "we do not believe that the proposed rule would impose any significant costs on persons effecting transactions or otherwise trading in security-based swaps."[9] MFA urges further consideration of both costs and benefits and believes that a more extensive analysis will show that the likely costs far exceed possible benefits.

As the Commission is aware, over the past decade, the OTC derivatives market has grown significantly in size and national economic importance.[10] That is true as well for the

---

[7] See 11 U.S.C. § 560.

[8] Under Section 3(f) of the Exchange Act, in considering or determining whether an action is necessary or appropriate in the public interest, the Commission must consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.

[9] 75 Fed. Reg. 68,560, 68,565-66 (Nov. 8, 2010).

[10] Between 2000 and 2009, the notional amount of OTC derivatives outstanding globally grew more than sixfold, from $95.2 trillion in 2000 to approximately $625 trillion in 2009. Financial Crisis Inquiry

security-based swaps markets. As of June 2010 the following instruments that will likely be deemed "security-based swaps" were outstanding:

- $18.4 trillion notional amount of single-name credit default swaps,
- $4.3 trillion notional amount of non-index multi-name credit default swaps, and
- $571 billion notional amount of equity linked forwards and swaps.

In addition, there is nearly $40 trillion notional amount of swaps outstanding that are deemed "unallocated" by the Bank of International Settlements ("BIS").[11] Some portion of these swaps may also be considered security-based swaps.

OTC derivatives are broadly recognized to "benefit financial markets and the wider economy by improving the pricing of risk, adding to liquidity and helping market participants manage their risks."[12] Similarly, the Financial Crisis Inquiry Commission ("FCIC") staff found that: "Many financial and commercial firms as well as governments use derivatives to hedge or manage their risks. For the financial system as a whole, derivatives can improve market efficiencies by providing price discovery and by transferring risks to those more willing and able to bear them."[13] By helping market participants mitigate risk and discover fundamental values, derivatives lubricate the issuance of new financial instruments, including new credit.

We are concerned that a swaps anti-fraud rule, such as Rule 9j-1, that is too vague and that sweeps too broadly would suppress legitimate trading activity and result in at least some loss of these benefits. Both we, in paragraphs above, and other commenters explained how adoption of the proposed rule would have these effects. Impairing the ability of market participants to use these instruments would increase the cost of risk-management and decrease market liquidity, price discovery, and transparency in credit-worthiness.

Any diminution in the legitimate swaps markets, given their size and scope, would be a significant cost from adopting Rule 9j-1. Curtailment of even a small fraction of the security-based swap market would have a material negative effect on the cost of credit as primary and secondary participants find it more difficult to hedge their credit and equity exposures. For example, we understand from information in the marketplace that, as of the end of 2010, there was approximately $650 billion in institutional leveraged loans outstanding, $1.2 trillion in high yield bonds outstanding, and $3.2 trillion in investment grade bonds outstanding. A very modest increase of only 15 bps for only 10 percent of these instruments would increase the annual cost of

---

Commission, The Financial Crisis Inquiry Report 48 (2011); Financial Stability Board, Implementing OTC Derivatives Market Reforms 8 (October 25, 2010).

[11] The data are available on the internet site for the Bank of International Settlements: http://www.bis.org/statistics/index htm. The notional amount of derivatives contracts is a standard measure used in reporting the outstanding volume of such contracts. The calculation of notional amount is based on the value of the instrument underlying the swap and may be of limited use in measuring the potential exposure of the parties to the contracts. See Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report 560, n. 37 of ch. 3 (2011).

[12] Financial Stability Board, Implementing OTC Derivatives Market Reforms 8 (October 25, 2010).

[13] Financial Crisis Inquiry Commission, Preliminary Staff Report, Overview on Derivatives 3-4 (June 29, 2010) (footnotes omitted).

debt by approximately $750 million. This is a conservative estimate that could increase significantly depending on the final language of an anti-fraud rule for the security-based swaps markets and the response of market participants.

Another approach to understanding the cost of an overbroad and vague rule is to look at the impact on primary debt issuance. In 2010, new issuance included:

- $386 billion of investment grade loans,
- $376 billion of leveraged and LBO-related loans,
- $324 billion of "other" corporate loans,
- $259 billion of high yield bonds, and
- $728 billion of investment grade bonds.[14]

If lenders and other market participants are not able adequately to hedge at least a portion of this newly issued debt, then original issuances would decrease, potentially to a significant degree. The chill on credit creation would reverberate throughout the U.S. economy and dampen growth. Precise quantification of this effect is elusive, but the consequences could be dramatic for the U.S. multi-trillion dollar economy.

Finally, the Commission should consider the costs of complying with a new, far-reaching rule, including the revision of policies, procedures, agreements, and documents commonly used in the market. The need to incur these costs of compliance would extend across the industry, and they would likely become sizable. A more narrowly tailored rule would reduce these costs.

The incremental anti-fraud benefits from proposed Rule 9j-1 are not likely to approach these costs. Without doubt, prohibiting fraud in the financial markets is important because all market participants, including the financially sophisticated parties that routinely enter into securities-based swaps, will be reluctant to participate in a market that they believe to be fraudulent or manipulated. That does not mean, however, that proposed Rule 9j-1 would contribute in a cost-effective way to the current anti-fraud protections. For several reasons, we do not believe that the rule as proposed would add meaningfully to the benefits already provided by the existing anti-fraud framework.

First, we are not aware that fraud in the purchase, sale, or performance of CDS or other securities-based swaps has been a major area for SEC enforcement or that fraud or manipulation in the performance of a party's obligations pursuant to securities-based swaps is a pervasive problem that needs to be addressed.[15] The proposing release did not identify (or quantify) an existing problem with fraud in the offer, purchase, or sale of security-based swaps or in the performance of obligations under such swaps. It did not refer to a single enforcement case or incident that could have been addressed by the proposed rule, and that absence is noteworthy given the size of the derivatives market and its over 600 percent growth in the past decade.

---

[14] See Ioana Barza, U.S.4Q 10 Loan Market Review, Reuters (December 31, 2010) available at http://www.loanpricing.com/press/pressdetail.php?yearValue=2010&press_release_info_id=8.

[15] In one highly publicized case that the Commission brought for insider trading through the use of CDS, the court ultimately found no fraud and no insider trading. SEC v. Rorech, 720 F. Supp. 2d 367, 371, 372, 373, 416 (S.D.N.Y. 2010).

Similarly, the FCIC never mentioned fraud and manipulation in the CDS and swaps markets when it sought to catalogue the causes of the financial crisis. The majority and the dissents spent a great many pages describing and discussing derivatives, particularly CDS, and they found many things about derivatives to criticize, but none of the Commissioners cited fraud, misrepresentation, manipulation, or other misconduct during the performance of swap contracts.[16]

Second, participants in the security-based swaps markets are sophisticated, well-advised, and well-financed. They are capable of and accustomed to protecting themselves and suing when necessary. The participants are by and large not individuals in the traditional retail markets. Providing extra government enforcement remedies to the many formal and informal private remedies that already exist, while providing some additional deterrence, would not appear to be as helpful in these circumstances as in others.

The SEC cited the promotion of "price efficiency" and "investor confidence in the integrity of the market" as potential benefits of the proposed rule. As active investors in the security-based swaps market, MFA members believe that, under the existing legal regime, the marketplace allows for efficient pricing of these swaps and the underlying instruments. The proposing release did not cite evidence of current pricing inefficiencies, such as a material dislocation between the value of the swaps and the reference obligation. While MFA members support even greater transparency and the move towards clearing, MFA members have confidence in the integrity of the existing market and, on the whole, do not refrain from active participation because of a concern about counterparty fraud addressed in proposed Rule 9j-1.

Accordingly, the challenge of drafting an anti-fraud rule for the security-based swap market is to have it address valid concerns of potential misconduct and provide additional benefits beyond the Commission's current anti-fraud prohibitions. Proposed Rule 9j-1 does not achieve those goals. It employs broad and expansive language reaching beyond purchases and sales to capture performance of security-based swaps. If Rule 9j-1 were revised as we suggest, to clarify the meaning of purchases and sales in the context of security-based swaps, there would be greater clarity about the scope of the anti-fraud protections provided by the federal securities laws to the security-based swap markets. The greater certainty could provide benefits without incurring the substantial costs that would accrue if the broadly drafted proposed Rule 9j-1 were adopted. We believe it is possible to achieve the benefits of an anti-fraud rule for securities-based swaps if the Commission adopts a carefully tailored rule in accordance with the suggestions outlined above.

* * * *

[16] See, e.g., Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report xviii, xxii, xxiv-xxv, ch. 10, 425-26, 447 (2011).

We thank the Commission for providing MFA an opportunity to discuss proposed Rule 9j-1 with the Commission. MFA is pleased to meet with the Commission or its staff further to discuss any questions or concerns. 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
Robert Cook, Director, Division of Trading and Markets
James Brigagliano, Deputy Director, Division of Trading and Markets
Brian Bussey, Associate Director, Division of Trading and Markets