July 8, 2011

Via email to rule-comments@sec.gov

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Re: Proposed Rule 9j-1; Release No. 34-63236; File No. S7-32-10

Dear Ms. Murphy:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to further comment on the Securities and Exchange Commission's (the "**Commission's**") proposed Rule 9j-1[2] under the Securities Exchange Act of 1934 (the "**Exchange Act**"). The Commission proposed Rule 9j-1 under Section 763(g) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), which expands the anti-manipulation provisions of Section 9 of the Exchange Act and authorizes the Commission to adopt rules to prevent fraud, manipulation and deception in connection with security-based swaps ("**SBS**").

We are concerned that the Proposal is overly broad and does not accurately reflect relevant differences between SBS and securities. We believe that the Proposal would expose SBS market participants to inappropriate enforcement liability, thereby discouraging them from entering into SBS transactions, which would hurt end users and other market participants seeking to manage risks. We also believe that any anti-manipulation rule must provide a

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, Exchange Act Release No. 63236 (Nov. 3, 2010), 75 FR 68560 (Nov. 8, 2010) (the "**Proposal**").

safe harbor analogous to Exchange Act Rule 10b5-1 ("**Rule 10b5-1**") for counterparties that obtain nonpublic material information after agreeing to the terms of an SBS. A rule to prevent manipulative conduct should apply exclusively to actions that involve a purchase or sale of an SBS, such as, for example, the unwinding, assignment or novation of SBS, not the pre-determined non-volitional acts that occur during the span of the SBS contract.[3] At the Commission's request, this letter is meant to provide examples of our concerns.

Potential Liability for Non-Volitional Actions

Further to our December 23, 2010 comment letter and our conversation with the Commission on March 2, 2010, SIFMA believes that the Proposal would inappropriately expose counterparties to liability in connection with standard events that take place during the lifecycle of an SBS transaction. Unlike a security, for which a purchase or sale is a one-time transaction that ends upon settlement, SBS transactions are ongoing contracts that involve rights and obligations throughout the life of the SBS.

In particular, SBS transactions involve a number of contractual rights and obligations that occur automatically, such as regular reset or settlement. As it relates to these rights, acquisition of material non-public information ("**MNPI**") makes no difference to exercise of the right or obligation and, as a result, manipulation concerns simply do not apply. We refer to these as "non-volitional" actions, rights or obligations. Applying the rule to actions unrelated to SBS investment decisions and actions that occur pursuant to pre-agreed contractual terms would be the equivalent of concluding that an issuer making interest payments on a bond (or a bond holder accepting such payments) violated Rule 10b-5 because it was in possession of material nonpublic information.

As a general matter, we believe that the Commission should allow and encourage counterparties to fulfill these non-volitional contractual obligations that were entered into prior to obtaining MNPI, regardless of whether that counterparty subsequently obtains MNPI. Enforcement authority should instead focus on cases where manipulation can occur when in possession of MNPI – namely, any purchase or sale of SBS rights, which can be achieved either through entering into new SBS or unwinding existing ones.

Particular examples of non-volitional actions are set out below:

- **Interim Settlement/Reset Payments.** SBS require the contracting parties to make interim settlement payments prior to the SBS' maturity.

[3] For CDS, the events that involve a purchase or sale of an SBS include: new volitional trades (e.g., those not part of a portfolio compression exercise); novations where the original party is not a remaining party; unwinds prior to a credit event or scheduled termination; and volitional amendments.

For example, a total return swap on an security may require one party to pay the difference between a fixed amount and an amount reflecting the value of the reference underlying, including dividends, on a quarterly basis. The obligation to make these payments, and the method of calculating the payments, are predetermined under the SBS contract.

Consider a counterparty that enters into an SBS transaction without any MNPI and thereafter, and before an interim settlement date, obtains MNPI with respect to the reference underlying. Under the proposed rule, the counterparty would be required to disclose the MNPI or abstain from performing its obligations under the contract, even though the MNPI plays no role in its obligation to make payment. Requiring parties to "disclose or abstain" MNPI, as in the securities context, would leave market participants in the position of choosing among: disclosing information to counterparties who may not want to know it because of the effect on their trading activity, violating the anti-fraud rule by performing their obligations under the SBS contract while in possession of MNPI or abstaining from performance and defaulting on the contract.

Moreover, most swap transactions are governed by a master agreement (*e.g.*, an ISDA master agreement) or, increasingly due to Dodd-Frank's requirements, a clearing agreement, each of which would allow a breach by one counterparty to give the other the right to terminate every transaction governed by the overarching agreement.[4] Thus, acquiring MNPI on a single reference underlying could allow the non-breaching counterparty to terminate all contracts under the agreement, regardless of the reference entity. To avoid these conflicts, market participants are likely to withdraw from the market, with deleterious effects for the end-users and other market participants who rely on them as liquidity providers for risk management products.

- **Counterparty Default.** Proposed Rule 9j-1 would also prevent an SBS party who acquires MNPI from exercising contractual termination rights if its counterparty defaults. Generally, counterparties agree upfront to a mutual right of early termination if the other counterparty defaults. Possession of MNPI on the underlying is irrelevant to the exercise of this

[4] It should be noted that there is a limitation on the default rights of a counterparty to a qualifying master netting agreement under the Prudential Supervisor Proposed Rule on Margin and Capital Requirements. The proposed definition of "qualifying master netting agreement" limits the default rights of a counterparty by prohibiting a qualifying master netting agreement from containing a provision that would permit a non-defaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter. Prudential Supervisor Proposed Rule on Margin and Capital Requirements for Covered Swap Entities, 76 FR 27564, 27588 (May 11, 2011).

right but, as described above, could prevent a counterparty from exercising it without becoming subject to enforcement liability.

In addition, most SBS contracts are governed by master or clearing agreements. Under some master agreements, a triggering event such as a counterparty default allows only for termination of the entire relationship with a defaulting counterparty, and would not allow termination on a swap by swap basis. Therefore, under the proposed rule, the possession of MNPI with respect to a single reference underlying could prevent a counterparty from terminating the relationship with the defaulting counterparty under a master agreement.

- **Collateral Transfers.** Counterparties to SBS often enter into Credit Support Annexes ("**CSAs**") or other agreements to post collateral. Under these arrangements, posting of independent amounts and variation margin are non-volitional. Under the proposed rule, if a party obtains MNPI after the execution of an SBS the party would be required to abstain from exercising its contractual rights with regard to the CSA or collateral arrangement. The counterparty would thereby be prevented from requesting additional collateral despite the fact that the collateral obligations were agreed upon prior to the acquisition of the MNPI. Under these circumstances, compliance with the "disclose or abstain" requirement of Proposed Rule 9j-1 would expose the counterparty to unnecessary credit risk. Similar issues may arise with respect to cleared swaps.

- **Triggering Events**. A CDS protection buyer makes periodic payments to a protection seller in exchange for a payment in the case of a triggering event on a reference entity.[5] Under the proposed rule, the acquisition of MNPI on the reference entity by either counterparty could preclude the counterparty from being able to perform its obligations or exercise its contractual rights under the CDS contract to receive the debt obligation or cash payment. Even when a CDS buyer has the option to deliver a range of eligible bonds or loans, if the firm has the proper information barriers in place, the MNPI would not factor into the investment decisions of the counterparties.

- **Corporate Actions.** Many SBS contracts require counterparties to make predetermined payments upon a corporate action relating to the underlying such as a merger, tender offer, stock dividend or rights

[5] For CDS, under ISDA Credit Derivatives Definitions and the 2009 ISDA protocols, the determination that a triggering event or a corporate action has occurred must be based on publicly available information and is generally made by market committees with both dealer and buy-side representation.

offering. The occurrence of these actions is completely outside the control of the parties to an SBS contract. Corporate actions may also lead to adjustments to the terms of a CDS contract. If a counterparty to a total return swap obtains MNPI regarding a stock dividend in the reference underlying after entering into the SBS transaction, its receipt of MNPI would prevent it from making or receiving payment, regardless of the fact that the MNPI did not impact the decision of either party.

- **SEC Guidance on Options Markets Practice.** An analogy to the equity options markets, which involves similar concerns, is apposite. SEC interpretive guidance on Rule 10b5-1 indicates that, when the timing and price of an options exercise are set by the terms of the option at the time of purchase, the option can be exercised even if the purchaser is in possession of MNPI. Because the option was entered into prior to the receipt of MNPI and because the applicable firm does not have control over the price and the timing of the exercise, the exercise of the option is not considered a separate investment decision and is not affected by the MNPI.[6]

As stated above, the anti-manipulation rule should be aimed at preventing manipulative conduct with respect to actions that are the equivalent of a purchase or sale of an SBS. Rights or obligations under an SBS are determined at the outset of the transaction, their performance is non-volitional and does not alter the risks assumed, or change the parties' obligations, and are therefore not purchases or sales.

Impact on Ordinary Course Trading in Reference Underlyings

The proposed rule exposes counterparties to enforcement liability with respect to certain legitimate, ordinary course, cash market activities with respect to SBS reference assets. This increased risk of enforcement could discourage hedging of SBS risks and potentially discourage orderly restructuring efforts.

- **Discouraging Orderly Restructuring Efforts.** For example, a bondholder who purchased CDS credit protection on the bond could be barred by the proposed rule from tendering the bond as part of a restructuring effort. The acquisition of MNPI regarding the restructuring effort would require the party to abstain from performing its obligations or exercising its rights with respect to the CDS or to disclose the MNPI to its counterparty. The impact would be to discourage bondholders who are also CDS holders from engaging in restructuring efforts.

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[6] SEC Division of Corporation Finance: Manual of Publicly Available Telephone Interpretations, Regulation FD and Rule 10b5-1, Fourth Supplement, Issued December 2000, http://www.sec.gov/interps/telephone/phonesupplement4.htm.

Negligent Mistake

Violations of Proposed Rule 9j-1(c) and (d) require only negligence, not scienter. The high volume nature of the SBS business coupled with the frequent settlement activities throughout the life of an SBS increases the potential for a mistake or delay due to human error to result in liability.

- **Mistakes In Calculating Interim Payments.** Mistakes in calculating a payment due under an SBS contract are not uncommon. A mistake such as this could expose a party to liability as it could be seen as "obtaining" money by means of a negligently untrue statement. The current, less disruptive, market practice is to allow the mistakes to be identified and resolved between the counterparties.

- **Errors Resulting In Delay of Payment.** Payment delays due to human error are also not uncommon, and could expose a party to liability under a negligence standard. Under current market practices, these errors are efficiently reconciled and resolved by back and middle office departments without a need for, or a worry of, potential antifraud enforcement exposure.

Subjecting every trading decision or payment under an SBS to an enforcement claim that someone knew or should have known that the action would operate as fraud or deceit on another person could potentially deter many parties from entering into SBS, increase their cost and distort the markets.

Request for Narrowly Tailored Rule and Safe Harbor

SIFMA recognizes that there are circumstances when the Commission's enforcement authority under a narrowly tailored rule is appropriate. For example, a counterparty's material misrepresentation (with scienter) about the amount of collateral it maintains on the underlying obligation would appropriately be within the ambit of the Commission's enforcement authority. This kind of misrepresentation might induce a counterparty to exercise or refrain from exercising its rights under the terms of the SBS transaction.

However, at a minimum, the Commission should adopt a safe harbor tailored to SBS transactions similar to Rule 10b5-1 of the Exchange Act. Rule 10b5-1 provides a safe harbor for persons who enter into a contract to purchase or sell a security and who later obtain MNPI before the consummation of the transaction.[7] In the context of SBS transactions, this kind of safe harbor should

[7] This affirmative defense is available to persons who, before becoming aware of MNPI, "entered into a binding contract to purchase or sell the security," "instructed another person to (…continued)

protect counterparties to an SBS for non-volitional actions taken during the life cycle of an SBS.

Moreover, industry participants currently have in place information barriers reasonably designed to prevent violations of Rule 10b-5. Information barriers between the "public" and "private" side of firms are reasonably designed to both prevent violations of Rule 10b-5 and satisfy the requirements of the affirmative defense under Rule 10b5-1(c)(2).[8] Rule 9j-1 should provide a similar safe harbor to allow for the continued effective use of information barriers to prevent trading in SBS from being deemed made on the basis of MNPI. If this safe harbor is not adopted, the public side of the applicable firm could be effectively prevented from trading SBS because of exposure to enforcement liability stemming from the private side's possession of MNPI (notwithstanding the fact that the firm's public side traders were unaware of the MNPI).

While the above referenced safe harbors would alleviate some of the concerns discussed in this letter, we strongly believe that the failure to amend the overly broad proposed rule would still lead to many of the harmful effects described above and in our comment letter to the Commission dated December 23, 2010, such as uncertainty regarding the legal consequences associated with entering into SBS transactions and decreased liquidity in the SBS market.

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The SBS market provides various benefits to the U.S. economy, including reducing borrowing costs and providing credit and financial risk management opportunities for corporations and institutional investors. Proposed Rule 9j-1, as drafted, would impose unworkable disclosure obligations to pre-negotiated SBS contracts. These disclosure obligations would impede the ability of market participants to continue to honor those terms and would create market uncertainty as to the performance of those contracts. In addition, the enforcement exposure that results from a negligence standard governing the wide range of ordinary course activities that may relate to an SBS transaction would deter many parties from entering into SBS, increase the cost of financial risk management and have other distorting effects on the market. An anti-manipulation rule that will apply to SBS should be tailored as narrowly as possible to prevent actual manipulation and

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(continued…)
purchase or sell the security" or "adopted a written plan for trading securities." Rule 10b5-1(c)(i)(A).

[8] Rule 10b5-1(c)(2) provides an affirmative defense to an action under Rule 10b-5 if, in addition to showing that the individual making investment decisions was not aware of the MNPI, the firm can demonstrate that it has implemented reasonable policies and procedures to ensure that individuals making investment decisions would not violate laws prohibiting trading on MNPI.

misconduct without raising costs for market participants and impeding important and legitimate market activities.

SIFMA thanks the Commission for the opportunity to further comment on the Proposal and for the Commission's consideration of SIFMA's views. We would be happy to discuss any additional questions you may have in connection with the Proposal.

Sincerely,

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cc: Robert Cook, Director, Division of Trading and Markets
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