



Consumer Federation of America



August 29, 2011

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

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

Dear Secretary Murphy:

We are writing on behalf of the Consumer Federation of America (CFA)¹ and Americans for Financial Reform² in response to the Commission's request for comment regarding proposed business conduct rules for security-based swap dealers and security-based swap participants. These proposed rules are neither consistent with congressional intent nor commensurate with the severity of the problems they are intended to address. Indeed, unless they are dramatically strengthened, they will do little to change the abusive practices that Congress targeted when it gave the Commission broad authority to regulate business conduct among security-based swap dealers (SBS Dealers) and major security-based swap participants (Major SBS Participants).

It is particularly disappointing that the Commission has proposed such a weak set of business conduct rules when it had the benefit of the Commodity Futures Trading Commission's previous excellent work in this area to draw on in developing its proposal. The CFTC proposal won strong support from investor advocates along with numerous concrete suggestions for needed improvements. We are dismayed that, despite a growing body of evidence of pervasive abuses and the enormous costs of not regulating this market, the Commission has proposed to substantially weaken rather than strengthen the CFTC proposal. Inevitably, the Commission's weaker proposal will be used as leverage by those attempting to undermine the CFTC effort.

¹ CFA is a non-profit association of approximately 300 national, state and local pro-consumer organizations founded in 1968 to represent the consumer interest through research, education and advocacy.

² Americans for Financial Reform is an unprecedented coalition of over 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, religious and business groups as well as Nobel Prize-winning economists. (Members of AFR are listed at the end of this letter in Appendix A.)

Thus, the Commission proposal not only threatens to provide inadequate protections in the security-based swap market, it also makes it more difficult for the CFTC to defend its effort to adopt appropriate reforms.

We cannot state strongly enough how imperative it is that the Commission adopt extensive revisions before finalizing these rules. To accomplish that goal, serious flaws in virtually every provision of the SEC proposal will need to be fixed. The following are among the highest priorities. Each is discussed in more detail below.

- In order to ensure that the rules deliver the enhanced protections for special entities that Congress intended, the Commission must eliminate the gaping loophole in the definition of “act as an advisor” that would otherwise enable SBS dealers to force special entities to sign away their right to best interest recommendations. In addition, it must revise the definition of “independent representative” to ensure that any such representative is free of undue influence from SBS Entities.
- Provide guidance with regard to the best interest standard. Any such guidance should make clear that the best interest standard is intended to provide protections that go beyond those of a suitability standard (including by requiring recommendation, from among the various suitable options, of the approach the SBS Entity believes to be best for the special entity). In addition, guidance should clarify that the best interest standard is consistent with various different methods of compensation and with proprietary trades, but that it requires the full disclosure of any conflicts of interest.
- Eliminate the alternative method of “compliance” with the proposed suitability standard – which makes it unlikely the standard would ever apply – and instead tweak the definition of recommendation and provide additional guidance on when the standard would apply to provide industry with greater clarity about when they would be subject to the standard.
- Strengthen “know your counterparty” requirements to bring them into line with the CFTC proposal and apply at least certain aspects of the requirements to Major SBS Participants.
- Improve financial incentive and conflict disclosures by including differential compensation for recommending different types of swaps (customized vs. standardized, for example) or for recommending swaps over other non-swap alternatives (e.g., conventional bonds) among the financial incentives that have to be disclosed. Clarify that other types of conflicts associated with the counterparty role, such as the fact that the SBS Entity may be trying to move a position off its books and is recommending the swap as part of that strategy, would also have to be disclosed.
- Improve risk disclosures by requiring a scenario analysis as part of the risk disclosures, by specifying other characteristics such as liquidity or the risks of uncleared swaps among those that have to be disclosed, and by explicitly requiring SBS Dealers and Major SBS Participants that recommend customized swaps to show the standardized alternative and provide an assessment of the relative risks and costs of the two approaches.

- Provide additional guidance on material characteristics beyond risks that would have to be disclosed. These should include a requirement to detail, and separately price, the standardized component parts of any customized swap, including any imbedded credit for forgone collateral.
- Set standards for the manner of disclosure that require risk, material characteristics, financial incentive and conflict disclosures to be provided in writing at the earliest possible point in advance of the transaction. Do not allow the use of master agreements to substitute for disclosure of conflicts, risks, or other material characteristics.
- Adopt standards regarding reliance on written representations to demonstrate compliance with Commission rules that require that the representations themselves be sufficiently detailed and informative to permit reliance and that require SBS Entities who wish to rely on those representations without further inquiry to have a reasonable basis for believing those representations to be true.
- Adopt execution standards comparable to those proposed by the CFTC.
- Generally bring the Commission proposal into line with stronger CFTC proposals in each of the areas covered by the rules.

Before discussing these and other aspects of the rule proposals in greater detail, it is appropriate to take a moment to reflect on the conditions that led Congress to provide the SEC and CFTC with broad new authority in this area. This is particularly important since an awareness of that context and the purpose behind the business conduct rules seems to be missing from the Commission proposal.

I. Background

The business conduct rules directly address a problem that was a root cause of the 2008 financial crisis: the change in culture on Wall Street. For a variety of reasons – the decision of investment banks to go public and an emphasis on proprietary trading rather than customer services as a major revenue source, for example – Wall Street firms no longer exist primarily to serve the needs of their customers. Indeed, industry insiders called to testify before the Senate Permanent Subcommittee on Investigations last year often seemed bewildered by suggestions that they should do so. In their world, everyone appears to take it for granted that products are designed to serve no economic purpose except to make the firm money, customers who can't look out for their own interests are simply sheep waiting to be shorn, and the only obligation is to maximize firm profits.

The indifference to consequences for customers exhibited in the Permanent Subcommittee's hearing is not a new or rare phenomenon. Similar conduct was on display as far back as the early 1990s, when Bankers Trust took supposedly "sophisticated" institutional investors, such as Gibson Greeting, Inc. and Procter & Gamble, to the cleaners selling them risky interest rate swaps based on complex mathematical formulas the customers clearly did not

understand. And the history of the over-the-counter derivatives market is littered with all too many similar examples, from Orange County, California in the 1990s to school districts and municipalities all across the country in the past decade. What comes through in accounts of these events over the years is not just that customers clearly lacked the financial knowledge and sophistication needed to assess the deals, but that the dealers fully recognized and intentionally exploited their lack of understanding. In his 2003 book *Infectious Greed*, for example, Frank Partnoy offers the following illustration of the culture at Bankers Trust:

As one former managing director put it, “Guys started making jokes on the trading floor about how they were hammering the customers. They were giving each other high fives. A junior person would turn to his senior guy and say, ‘I can get [this customer] for all these points.’ The senior guys would say, ‘Yeah, ream him.’”³

When the Senate Permanent Subcommittee on Investigations held its hearings last year on the role of investment banks in the financial crisis, little appeared to have changed. Among other things, the hearing highlighted the practices at Goldman and other investment banks that created “a conflict between the firm’s proprietary interests and the interests of its clients” by trading “billions of dollars in mortgage related assets for the benefit of the firm without disclosing its proprietary positions to clients.”⁴ Particularly revealing was the description of Goldman Sachs’ actions as it sought to reduce its own exposure to and then bet against a mortgage market it viewed as headed for serious trouble.

According to Subcommittee documents, Goldman began in late 2006 to instruct its sales force to sell mortgage-backed securities and CDOs “containing or referencing high risk assets that Goldman Sachs wanted to get off its books.”⁵ Various emails among Goldman employees refer to the investments “as a way to distribute junk that nobody was dumb enough to take first time around,” and they refer to certain clients as “too smart to buy this junk.”⁶ The implication, of course, is that there were other clients who weren’t as smart. One Goldman employee describes the “real bad feeling across European sales about some of the trades we did with clients,” trades that had cost clients more than \$1 billion in losses on just five deals. Adding to the resentment in the latter case, the team did not feel it had been adequately rewarded “for getting this business done” considering all the money it “ended making/saving the firm.”⁷ In other words, Goldman and other investment banks weren’t simply passively agreeing to act as counterparties in these trades, they were aggressively pushing deals that they had reason to believe would be harmful to their customers’ interests.

³ Frank Partnoy, *Infectious Greed, How Deceit and Risk Corrupted the Financial Markets*, Henry Holt and Company (New York), 2003, p. 55, citing Brett D. Fromson, “Guess What? The Loss is Now ... \$20 Million: How Bankers Trust Sold Gibson Greetings a Disaster,” *Washington Post*, June 11, 1995, p. A1.

⁴ U.S. Senate Permanent Subcommittee on Investigations Press Release, “Senate Subcommittee Holds Fourth Hearing on Wall Street and the Financial Crisis: The Role of Investment Banks,” April 26, 2010.

⁵ Chris V. Nicholson, “Deal Book: The Goldman Emails, or How to Sell Junk,” *The New York Times*, April 28, 2010.

⁶ *Ibid.*

⁷ *Ibid.*

While the Permanent Subcommittee hearings and related media coverage were very much on members' minds as they drafted the business conduct provisions of the act, they were also influenced by accounts of a different form of abusive conduct in the swaps market. In this case, the victims were municipalities, sewer districts, and school districts throughout the country that were sold complex financial transactions, purportedly to lower their interest rates, but which exposed them to risks far greater than those they sought to hedge. As described in several *New York Times* accounts, these small time players were "ensnared in the derivatives mess" because of municipal swaps that blew up when the credit markets collapsed.⁸ Even before that collapse, however, the U.S. Justice Department had reportedly launched a criminal investigation looking at whether J.P. Morgan and others conspired to overcharge governments on "swaptions."⁹ And a number of government bodies had filed lawsuits challenging excessive fees and other features of the transactions.¹⁰ In November 2009, Pennsylvania's Auditor General issued a report that called for a ban on the use of interest rate swaps and other derivatives by local government units and municipal authorities.¹¹

The most notorious such case involved the Commission's own probe into J.P. Morgan Chase & Co.'s sale of derivatives to Jefferson County, Alabama to finance a new sewer system. In November of 2009, the bank agreed to a \$722 million settlement that required it to pay a fine of \$25 million, to pay \$50 million to the county to assist displaced county employees, residents, and sewer ratepayers, and to cancel \$647 million in fees it had charged the county to unwind the derivatives transactions in question.¹² As the Commission well knows, the charges that were settled involved pay-to-play allegations and millions in bribes that landed one county official in jail. Bad as the bribery and corruption were, however, the real scandal is the underlying conduct, in which J.P. Morgan sold the county billions of dollars of derivatives that profited J.P. Morgan handsomely but has brought the county to the brink of bankruptcy.

Over the course of the sewer financing project, Jefferson County reportedly did 23 swap deals, leaving it at one point with more outstanding swaps than New York City.¹³ In 2008, however, a series of penalties built into the swaps deals began to kick in, including one related to failed insurance on the deal that forced the county to pay off \$800 million of its debt in four years instead of 40. As a result, the annual payment on Jefferson County's debt jumped from \$53 million in 2008 to \$636 million in 2009. There were other problems with the swaps, including a mismatch in interest rates paid that left the county getting lower payments from J.P. Morgan than it was forced to pay out to bondholders. When the county was unable to make its swap payment to J.P. Morgan, the bank cancelled the deal, charging the \$647 million termination

⁸ Gretchen Morgenson, "The Swaps That Swallowed Your Town," *The New York Times*, March 2010. See also Don Van Natta Jr., "Firm Acted as Tutor in Selling Towns Risky Deals," *The New York Times*, April 8, 2009.

⁹ Naked Capitalism, "JP Morgan Under Criminal Investigation for Jefferson County, Other Swaps," Oct. 29, 2008, quoting a *Bloomberg* article.

¹⁰ *Ibid.*

¹¹ Jack Wagner, Auditor General, "A Special Investigation of the Bethlehem Area School District, Lehigh/Northampton Counties: A Case Study of the Use of Qualified Interest Rate Management Agreements ("Swaps") by Local Government Units in Pennsylvania, With Recommendations," November 2009.

¹² Securities and Exchange Commission, "J.P. Morgan Settles SEC Charges in Jefferson County, Ala. Illegal Payments Scheme," November 4, 2009.

¹³ The description in this paragraph comes from an article by Matt Taibbi, "Looting Main Street: How the nation's biggest banks are ripping of American cities with the same predatory deals that brought down Greece," *Rolling Stone*, March 31, 2010.

fee that it was ultimately required by the SEC settlement to relinquish. But prior to passage of Dodd-Frank, that underlying conduct was not illegal and, absent strong business conduct rules, it is unlikely to be eradicated.

Cases such as these have a very direct and painful impact on taxpayers and pension recipients and endowments that fall victim. Jefferson County, for example, has seen its credit rating slashed. It has laid off workers, increased sewer bills by more than 400 percent, and it is still weighted down with billions in debt that will either force the county into bankruptcy or require county taxpayers to continue paying off the debt for decades to come. As journalist Matt Taibbi concludes in his account of the fiasco:

The destruction of Jefferson County reveals the basic battle plan of these modern barbarians, the way that banks like JP Morgan and Goldman Sachs have systematically set out to pillage towns and cities from Pittsburgh to Athens. These guys aren't number-crunching whizzes making smart investments; what they do is find suckers in some municipal-finance department, corner them in complex lose-lose deals and flay them alive. In a complete subversion of free-market principles, they take no risk, score deals based on political influence rather than competition, keep consumers in the dark – and walk away with big money.¹⁴

Econned author Yves Smith, writing in a blog about another deal involving J.P. Morgan, makes a similar point. Working from an account in a *Bloomberg* article, she notes that, if correctly described, “this looks like a deal almost certain to have turned out badly for the county.” “This is not at all uncommon for OTC derivatives,” she added, “where even if the transaction in theory has merit, the fees charged are so high as to make the deal uneconomical to the client. But clients almost universally lack the skills to properly model the deal to figure this out. Most deals don't blow up as spectacularly as this one did, so most clients never figure out they were had.”¹⁵

It is against this back-drop of widespread swap dealer abuses targeting everyone from tiny school districts to giant international banks that Congress drafted and adopted provisions as part of the Dodd-Frank Act granting the SEC and CFTC broad authority to adopt business conduct rules for swaps dealers and major swaps participants. Since the legislation was adopted, additional details have come to light that add urgency to the call for strong implementing regulations. A recent *New York Times* article by Pulitzer Prize winning financial writer Gretchen Morgenson, for example, describes the role that Wall Street has played in the worsening financial problems of municipalities around the nation.¹⁶ Drawing in part on testimony from a recent Commission hearing on municipal securities, the article describes Wall Street's “multibillion-dollar hidden tax on Main Street” in the form of hidden and excessive fees in the interest rate swaps peddled to municipalities and other borrowers seeking to exchange variable-

¹⁴ Ibid.

¹⁵ Yves Smith, “JP Morgan Under Criminal Investigation for Jefferson Country, Other Swaps,” *Naked Capitalism* blog, Oct. 29, 2008, available at: <http://www.nakedcapitalism.com/2008/10/jp-morgan-under-criminal-investigation.html>.

¹⁶ Gretchen Morgenson, “Wall Street's Tax on Main Street,” *The New York Times*, August 6, 2011 available at: http://www.nytimes.com/2011/08/07/business/wall-streets-tax-on-main-street.html?_r=1&emc=eta1.

rate debt for fixed-rate obligations. One expert testified that the deals, which are lucrative for the banks but poorly understood by many issuers, have cost taxpayers \$20 billion over the last five years alone.

The article describes a variety of features that make the interest rate swaps attractive for banks but costly for users:

- The lack of a central market which leaves costs “shrouded in secrecy” and allows for significant hidden mark-ups;
- Agreements that force borrowers who want to unwind the deals to go back to the bank that created them, putting those borrowers at a disadvantage;
- Onerous costs of unwinding the deals that are unjustified based on the risks;
- Generous bonuses for salespeople that create incentives to push the swaps;
- A tendency by cities and counties to view the dealer selling the swaps as a financial adviser;
- The fact that the deals are considered to be exempt from FINRA fair practice rules, such as rules prohibiting excessive mark-ups; and
- A widespread willingness to take advantage of customers’ lack of sophistication to profit at their expense.

It is with these sorts of abuses in mind that the Commission should fashion the rules to implement those standards. To effectively eliminate potential abuses, the rules must:

- Apply broadly, scaling the rules and conduct standard to match the degree of reliance by the counterparty on the SBS Entity;
- Impose an obligation to make suitable recommendation any time the swap dealer recommends a swap, particularly a customized swap;
- Require adequate transparency to ensure that the other party to the transaction can fully understand the characteristics, including in particular the costs and risks, associated with any transaction;
- Require that the full range of conflicts of interest between the swap dealer and counterparty are fully disclosed and clearly explained;
- Provide additional protections, including by imposing a best interest standard, where the swap dealer offers or enters into a swap with a “special entity” or other particularly unsophisticated counterparty; and

- Require sufficient documentation to enable the Commission to easily determine compliance with the business conduct rules.

As measured against this set of principles, virtually every aspect of the Commission proposal is seriously flawed. Unless the rules are extensively revised, they will do little or nothing to end these pervasive abuses. Our detailed responses to the Commission's request for comment follow.

II. Approach to Drafting the Proposed Rules

Before launching into its rule proposal, the Commission provides some introductory comments on its general approach to drafting the proposed rules. This section responds to this discussion.

A. SRO Rules as a Potential Point of Reference

The Commission appropriately suggests that business conduct rules adopted by self-regulatory organizations can provide a useful point of reference for the Commission as it adopts business conduct rules for SBS Entities. We agree. To the extent that other regulatory entities have already thought through and dealt effectively with the issues raised with regard to business conduct rules for swap dealers and major swap participants, there is every reason to take advantage of that experience. We are concerned, however, that in its discussion of this approach, the Commission does not appear even to contemplate that it might be necessary to go beyond existing standards in certain areas. It would have been appropriate, for example, for the Commission to note the need to reexamine the adequacy of business conduct rules that proved ineffective in preventing many of the abuses that led to the financial crisis. In particular, the Commission could and should have drawn attention to the fact that the scale of potential profits in the derivatives market creates conflicts of interest that dwarf those in the retail securities markets. Similarly, the Commission could and should have made the point that the potential harm to the overall economy from abusive practices in the swaps market is far greater than it is for most traditional securities transactions. That fact was made all too clear in the recent financial crisis which, according to the Financial Crisis Inquiry Commission, erased \$11 billion in household wealth and caused extensive additional harm to businesses "large and small."¹⁷

Thus, a strong case can be made for adopting a more stringent set of business conduct rules in certain areas, but the Commission fails to make it. Instead, the only reason the Commission cites for possibly diverging from existing SRO standards is the institutional nature of the swap market. By ignoring the factors that would justify issuing stronger standards, and citing extensive reasons for not diverging from existing standards, the Commission risks undermining its ability to take the effective action needed to address serious and pervasive abuses. At a time when the industry has made no secret of its intention to challenge agency actions in court, the Commission must do a better job of explaining the public interest rationale for adopting the strongest possible set of reforms. Unfortunately, the timidity the Commission

¹⁷ Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, January 2011.

shows in arguing for strengthened standards is also reflected throughout the rule proposals themselves, as discussed in greater detail below.

B. Business Conduct Rules Not Expressly Addressed by the Dodd-Frank Act

Dodd-Frank grants the Commission broad authority to adopt business conduct rules “as appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Exchange Act.” Indeed, the statute states not only that the Commission “may” adopt such additional requirements, but that it “shall” do so. This suggests that Congress intended to identify certain key components that would be included in the business conduct rules but fully expected the Commission to expand on those requirements with a goal of creating a comprehensive business conduct regulatory regime. The Commission is therefore clearly within its authority to adopt business conduct rules not specified in the statute, and the three areas it has identified – know your counterparty, suitability, and pay-to-play – are all appropriate areas for the Commission to exercise this authority. All are consistent with the principles of Dodd-Frank. All meet the test of promoting the public interest, the protection of investors, and the purposes of the Exchange Act. Most importantly, all are directly responsive to abusive practices identified in this market.

C. Differences between SBS Dealers and Major SBS Participants

We agree that it may be appropriate, in light of their somewhat different roles, to adopt different approaches to rules governing SBS Dealers and Major SBS Participants in certain areas. We are concerned, however, that the Commission approach to determining when this should be the case is not appropriate. The approach should not depend on whether the statute expressly directs that the rule apply to major swap participants. The determining factor should be whether major swap participants are likely to be engaged in conduct that would appropriately be regulated under the relevant standard. Absent an affirmative reason to adopt a different approach for SBS Dealers and Major SBS Participants, the Commission should seek to promote consistency and adopt uniformly strong rules.

D. Treatment of Special Entities

In discussing the rule provisions related to “special entities,” the Commission indicates that its goal was to strike a balance between enhancing protections and preserving access to the derivatives markets for these entities. That is appropriate, as far as it goes, but it ignores or misinterprets the legislative history behind these proposals. The provisions regarding special entities reflected Congress’s outraged response to evidence of derivatives dealers’ callous disregard for the well-being of their customers and cynical willingness to profit at the expense of the least sophisticated among these customers. This willingness to take advantage of less sophisticated market participants had resulted in devastating harm to communities throughout the nation. Congress’s initial response was to propose that a full-fledged ERISA-style fiduciary duty be applied to all transactions between swaps dealers and special entities. It was in this context that concern about preserving access to the derivatives market was raised, since this approach arguably would have prevented swaps dealers from both making recommendations and acting as counterparties. Ultimately, a compromise was drafted that sought to impose a less restrictive

“best interest” standard on swaps dealers when they recommended swaps to special entities while preserving their ability to act as counterparties in such transactions.

In adopting rules to implement this section of the legislation, the Commission should respect congressional intent to provide the strongest protections possible for these special entities consistent with preserving their access to derivatives markets. In keeping with this goal, the rules should be designed to put a stop to abusive practices that prey on special entities’ lack of sophistication. Current practices, in which derivatives dealers have lured these unsophisticated players into the derivatives markets when they would have been better served by more traditional debt instruments, should be eradicated. As should the practice of recommending products to hedge risks that actually expose the special entities to risks that are greater than those they are hedging. Recommending customized swaps when the special entity would be better off in a standardized swap should also be eliminated. In other words, the goal is not to preserve access to these markets on the same terms that access exists today, but to preserve access to these markets when it is in the best interests of the special entity to do so and on terms that promote their interests.

Unfortunately, the Commission has taken the opposite approach, giving far greater priority to preserving unrestricted market access than it has to enhancing protections for special entities. Under the approach proposed by the Commission, SBS Dealers would be free to require special entities to sign away their right to best interest recommendations as a condition of participating in the markets. We have no doubt that they would do so. When this occurs, special entities would have as their only defense advice from an “independent” representative who, under the Commission definition of independence, could be completely financially beholden to the SBS industry. It is not even entirely clear from the discussion in the proposing Release that the Commission interprets the best interest standard as imposing obligations beyond making suitable recommendations. Under the circumstances, it is hard to see how the proposed rules will deliver any significant new protections for special entities.

III. Comment on Proposed Rules

This section of our letter deals with specific aspects of the proposed rules in the order they are raised in the Commission’s proposing release. We address most but not all of the issues on which the Commission requests comment. Our comments are informed by our direct and detailed involvement in the congressional negotiations over this section of the legislation. In addition, because we believe market participants are best served by uniform rules (so long as they are uniformly strong and not uniformly weak), we make frequent reference to the CFTC’s proposals to address the same issues.

A. Scope: Proposed Rule 15Fh-1

Getting the scope of the rules right is an essential first step in designing an effective business conduct rule regime. Unfortunately, the SEC falls somewhat short in this regard then threatens to exacerbate this problem by requesting comment on several approaches that would completely undermine the rules’ effectiveness. We therefore urge the SEC to expand its interpretation of the rules’ scope as described below and to reject approaches that would allow

counterparties to opt out of enhanced protections, that would elevate procedures over results in determining compliance with the rules, or that would permit SBS Entities to rely on counterparty representations they have no reason to believe are true.

Scope: The CFTC makes clear in its proposal that the business conduct standards would apply to swaps that are offered as well as those that are entered into. The SEC proposal indicates these rules would apply “in connection with entering into security-based swaps.” As we stated in our letter to the CFTC: “For the business conduct rules to provide meaningful protections, they must apply from the outset of any discussions between the swap dealer or major swap participant and the potential counterparty about a particular transaction or trading strategy. That can only occur if, as the Commission has proposed, the rules apply to offers to enter into swaps and discussions with prospective counterparties as well as to transactions that are actually consummated.” There is no good policy reason to exempt offers to enter into swaps from the rules, and there is a strong policy reason to ensure that the two agencies’ rules don’t diverge on this basic issue of scope. We therefore urge the Commission to amend its rule to conform to the approach adopted by the CFTC. On the other hand, the SEC proposal makes clear, in a way that the CFTC proposal does not, that the requirements would “continue to apply, as appropriate, over the term of executed security-based swaps.” While we believe the on-going obligation is implied under the CFTC approach, it would nonetheless be beneficial for the CFTC to clarify that this is its intent.

Opt Out: The Commission requests comment on whether certain counterparties subject to enhanced protections should be allowed to “opt out” of those additional protections. We strongly oppose this approach. As derivatives expert Richard Bookstaber noted in testimony before the Senate Agriculture Committee, counterparties’ motives for turning to the derivatives market are not always entirely pure. “Derivatives have been used to solve various non-economic problems, basically helping institutions game the system” by hiding risk-taking activities, for example, or taking exposures not permitted by a particular investment charter. “These non-economic objectives are best accomplished by designing derivatives that are complex and opaque, so that the gaming of the system is not readily apparent,” he explained.¹⁸ A high-profile recent example can be found in the derivative contracts that allowed Greece to hide its level of indebtedness until the problem was so severe it could no longer be obscured. Allowing counterparties to opt out of special protections under business conduct rules could encourage collusion between them and swaps dealers to promote these questionable practices. On the other hand, a theoretically optional opt out would likely become mandatory in reality as swap dealers would almost certainly make it a condition of doing business with counterparties subject to enhanced protections. In short, this opt out approach could be used to perpetuate the very abuses the legislation was enacted to prevent.

That does not mean that the rules should apply, or apply equally, in every situation. Rather, they should be designed to be scalable, based on the degree of reliance in the counterparty relationship. This would provide necessary flexibility in applying the rules without creating a means for circumventing them entirely. The discussion in the CFTC rule proposal offers a good model for this approach. The CFTC specifies, for example, that the rules would

¹⁸ Testimony of Richard Bookstaber before the Senate Committee on Agriculture, Nutrition and Forestry, “Regulatory Reform and the Derivatives Markets,” June 4, 2009.

have the most applicability “when swap dealers and major swap participants have a pre-trade relationship with their counterparty, where that relationship includes discussion and negotiations that would allow a swap dealer or major swap participant to make appropriate disclosures and conduct due diligence.” On the other hand, transactions initiated on a designated contract market (DCM) or swap execution facility (SEF) where the swap dealer or major swap participant does not know the counterparty’s identity prior to execution and transactions where both parties to the deal are swap dealers or major swap participants would largely be exempt. In the first instance, the exemption is justified because there can, by definition, be no reliance by one party on the recommendations of the other in an anonymous transaction. In the second instance, where both parties are market professionals, both should have the sophistication and expertise to look out for their own interests that other market participants often lack.

Policies and Procedures: The Commission also requests comment on whether an SBS Entity should be deemed to have complied with the requirements of the rules if it: 1) has established and maintained written policies and procedures, and a documented system for applying those policies and procedures, that are reasonably designed to achieve compliance with the requirement; and 2) has reasonably discharged the duties and obligations required by the written policies and procedures and documented system and did not have a reasonable basis to believe that the written policies and procedures and documented system were not being followed. We strongly oppose this approach, which puts process over results in measuring compliance with business conduct rules. That said, it is certainly appropriate for the Commission to require SBS Entities to establish, maintain, document and enforce policies and procedures reasonably designed to achieve compliance with business conduct rules. In addition, it would be appropriate for the Commission to take that into account in determining the appropriate sanction for violations. But the requirement regarding policies and procedures should supplement the requirements or prohibitions in the rules, not supplant them. Under no circumstances should the Commission provide what amounts to a safe harbor from sanctions based on the existence of compliance policies and procedures.

Counterparty Representations: Having proposed an approach that allows SBS Entities to rely on counterparty representations absent special circumstances, the Commission requests comment on when it would no longer be appropriate for an SBS Entity to rely on counterparty representations without further inquiry. It offers two alternative approaches. The first would allow the SBS Entity to rely on a counterparty representation unless it knows the representation is not accurate. We are frankly appalled that the Commission would even propose for comment an approach that would allow SBS Entities to rely without further inquiry on representations they have reason to believe, but do not affirmatively know, are not accurate. Such an approach would encourage a cynical disregard for the rules and, where counterparties are seeking to use derivatives to evade legal or other restrictions, promote the kind of collusion between swap dealers and counterparties described above. The second approach, which would allow SBS Entities to rely without further inquiry on counterparty representations unless it has information that would cause a reasonable person to question the accuracy of the representation, is only slightly better. It encourages a see-no-evil approach that is likely to be ineffective in preventing abuses.

While we believe it is appropriate for the Commission to adopt a standard addressing the circumstances in which it is appropriate for SBS Entities to rely on counterparty representations to establish compliance with the proposed rules, neither of the two proposed approaches is satisfactory. Instead, the Commission should adopt the approach proposed by the CFTC, which would require that the swap entity have a reasonable basis for believing the representations are reliable in light of the particular facts and circumstances of the relationship and the context of the particular transaction. Importantly, the CFTC proposal would also require that the representations be sufficiently detailed to allow such an assessment. As such, and if subject to appropriate documentation and record retention requirements, the CFTC proposed approach should provide an adequate basis for regulators to enforce compliance without being unduly prescriptive in laying out the means of compliance. It should serve as a model for the SEC, both because of the benefits of uniformity of approach and because it would promote market integrity in a way that the two options under consideration by the SEC would not.

B. Definitions: Proposed Rule 15Fh-2

This section of the proposed rules includes definitions of key terms that are crucial to determining the rules' effectiveness, particularly with regard to the protections provided special entities. Unfortunately, the definitions of "act as an advisor" and "independent representative of a special entity" are so weak that the rules, as proposed, would afford no meaningful new protections to these most vulnerable of swap market participants. (Our discussion of those definitions is included below as part of our overall discussion of the rules related to special entities.) In addition, because the definitions of SBS Dealer and Major SBS Participant fail to include all those who act on behalf of these entities, they risk providing a means to evade the rules' restrictions.

Associated Persons: The Commission proposes to include, where relevant, associated persons within the definition of SBS Dealer and Major SBS Participant. In contrast, the CFTC proposes to include not just associated persons but also all those acting on behalf of the swap dealer or major swap participant, including but not limited to associated persons. This broader approach proposed by the CFTC should help to ensure that swap entities will not be able to evade the business conduct rules by doing through third parties what they would not be permitted to do directly. We strongly urge the Commission to adopt this approach, both for the sake of promoting uniformity between SEC and CFTC rules and because the CFTC approach is likely to be more effective than the narrower SEC proposal in promoting market integrity. On the other hand, we do not believe the Commission should seek to identify all of the requirements that would apply to an associated person of an SBS Entity. Such an approach risks creating loopholes that would subvert compliance. Instead, the rules should apply in any circumstance where the SBS Dealer or Major SBS Participant acts through or by means of that associated person or other party. If, on the other hand, the Commission decides it would be appropriate to identify specific rules that apply to associated persons, it should make clear that any such list is not intended to be exclusive and that rules might apply in other instances, depending on the circumstances.

C. Business Conduct Requirements: Proposed Rule 15Fh-3

1. Counterparty Status

The CFTC proposed a sound and reasonable approach to verification of counterparty eligibility. In the interest of uniformity and because the CFTC proposal is superior in several areas, we urge the Commission to revise its proposal to more closely resemble the approach proposed by the CFTC. In addition to being more clearly written than the comparable Commission proposal, the CFTC proposal imposes the counterparty verification obligation in any transaction other than those which are both initiated on a swap execution facility and in which the swap entity does not know the identity of the counterparty prior to the transaction. Thus, even transactions executed on a SEF would be covered if the identity of the counterparty is known in advance, as would any transaction not conducted on a SEF. Moreover, the CFTC proposal requires the verification to occur before offering to enter into or entering into a swap with that counterparty. As part of its verification obligation, the swap dealer or major swap participant would have an affirmative obligation to determine whether the counterparty is a Special Entity, with that verification also occurring before the offer to enter into a transaction.

In contrast, the Commission proposal is written to exempt any transaction that occurs on a registered national securities exchange or registered security-based swap execution facility, regardless of whether the identity of the counterparty is known in advance of the transaction, and to exempt any transaction in which the identity of the counterparty is unknown, regardless of where the transaction occurs. The obligation to verify whether the counterparty is a Special Entity is similarly limited to circumstances in which the identity of the counterparty is known. Finally, the Commission proposal requires verification to occur before execution but not before the offer to enter into the transaction.

The Commission justifies exempting transactions on exchanges and SEFs from the counterparty verification requirement because related rules hold these execution facilities responsible for limiting access to eligible counterparties. That is reasonable, with one caveat. Execution facilities may not have perfect compliance in this regard. We would therefore urge the Commission to alter its proposal to make clear that, where the SBS Entity knows the identity of the counterparty prior to the transaction and has reason to believe it may not be an eligible counterparty, it would have an obligation to undertake an additional inquiry to verify counterparty eligibility.

More importantly, we oppose exempting any transactions that are not conducted on a registered exchange or swap execution facility from the verification requirement. We cannot imagine a circumstance in which the identity of the counterparty would not be known in such transactions; certainly it would not be possible to satisfy know-your-counterparty and suitability obligations without knowing the identity of the counterparty. Providing an exemption seems to invite the creation of a mechanism to permit anonymous off-exchange transactions, particularly if the pay-off is avoidance of the obligations owed to Special Entities. It can serve no beneficial purpose.

We also prefer the wording of the CFTC proposal with regard to timing before the offer to enter into the transaction over the Commission's pre-execution approach. Certainly, the verification can come no later than that allowed for in the Commission proposal. The Commission suggests that pre-execution verification is "important." We believe it is not just important, but absolutely essential. In particular, requiring verification of the counterparty's Special Entity status as soon as possible is necessary to ensure timely compliance with the other obligations that accompany transactions with these entities.

Finally, while we believe it is appropriate to allow reliance on written representations to satisfy compliance with this requirement, neither of the two alternatives proposed by the Commission is adequate. Indeed, the first alternative is shockingly weak and should not even have been proposed. It would invite the creation of a SBS market equivalent of the mortgage market's "liar loans." Instead, the Commission should adopt the approach proposed by the CFTC but with one addition; the Commission should clarify that the SBS Entity is required to document the basis on which it reached its conclusion, to do so in sufficient detail to allow a third-party to evaluate the validity of the conclusion, and to make those records available for Commission inspection. This approach would enable the Commission to provide effective enforcement of the requirement in a way that neither of the Commission's two proposed alternatives would do. Moreover, this requirement should impose minimal if any additional compliance costs, since it is difficult to imagine that SBS Entities could satisfy their know your counterparty obligations without obtaining information that would enable them to verify eligibility and Special Entity status at the same time.

2. Disclosure

Getting the disclosures right is central to preventing the types of abuses that prompted Congress to provide the Commission with such broad authority to set business conduct standards. Although the swaps market is theoretically closed to all but sophisticated parties, the reality is that the complexity and opacity of these transactions has made old notions of financial sophistication obsolete. All too often, corporations and government entities alike have failed to understand the magnitude of the risks they were taking on – a particularly egregious failing in a market the most important and valuable function of which is to help counterparties hedge risks. For disclosures to be effective, they must meet three essential requirements: they must provide the information the counterparty needs, in an accessible form, at a time when it can influence the decision-making process.

When we commented on the CFTC's proposal, we expressed strong overall support for that agency's approach to disclosure. In particular, we praised the CFTC's proposal to include scenario analysis as part of the required risk disclosures while urging the agency to strengthen that proposal and offering specific suggestions for doing so. Instead of building on the CFTC proposal, however, the Commission's proposed risk disclosures fall well short, particularly with regard to the content of risk disclosures. Moreover, the Commission fails to set any standards regarding the manner of that disclosure. As a result, even the modest disclosures required by the Commission are likely to be delivered in a form that severely undermines their effectiveness. In order to ensure that the disclosures have their intended effect of promoting informed investment

decision-making, the Commission should strengthen this proposal both by setting standards governing the manner of disclosure and by expanding the required risk disclosures.

a. Disclosure Not Required When the Counterparty Is an SBS Entity or a Swap Dealer or a Major Swap Participant

We agree with the Commission interpretation that Congress intended the swap dealer/major swap participant exemption in this section to mirror that provided with regard to non-security-based swaps. In discussing the exemption, the Commission also requests comment on whether other entities should be exempted or subject to different disclosure requirements. We would strongly discourage the Commission from adopting either approach. Any attempt to go beyond the statutory exemption to specify different types or amounts of disclosure for different types of counterparties risks leaving certain counterparties without adequate warning of risks and conflicts. For example, the Commission cites registered broker-dealers or banks as entities that might not need the same degree of disclosures. While this may be true of certain more sophisticated banks or brokers, it would not necessarily be true of all such entities. Setting reduced disclosure requirements that might be acceptable for the most sophisticated entities in these categories would thus leave the less sophisticated entities in these categories without adequate protections. Under the circumstances, the Commission should err on the side of promoting transparency by avoiding additional exemptions or disclosure disparities.

b. Timing and Manner of Certain Disclosures

Timing: The Commission appropriately proposes to require that disclosures of material risks and characteristics, material incentives and conflicts of interests, and clearing rights be presented before entry into a security-based swap. However, unlike the CFTC proposal, the Commission does not specify that the disclosures should come at “a reasonably sufficient” time prior to the transaction to enable the counterparty to consider these factors in evaluating the transaction. As a result, nothing in the current formulation of the rule would prevent the disclosures from being provided immediately prior to execution without adequate time for the counterparty to carefully evaluate the information provided. We urge the Commission to make clear that these disclosures must be provided at the earliest possible point in the transaction and not delayed until the point of execution.

Manner: The Commission proposes that disclosures regarding material risks and characteristics and material incentives or conflicts of interest be made “in a manner reasonably designed to allow the counterparty to assess” the information being provided. However, it sets no standards to ensure that this is the case. Worse, it blesses disclosure methods, including oral disclosures, that clearly do not satisfy the goal of promoting pre-transaction transparency and that will make the disclosure rules far more difficult, if not impossible, to enforce. This approach is an open invitation to SBS Entities to manipulate and abuse the system. Moreover, this approach doesn’t even have the benefit of saving labor, since the Commission proposes to require after-the-fact written disclosures of any information not made in writing prior to the transaction. Indeed, the only recommendation of this approach appears to be to change as little as possible about the way the industry conducts its business, precisely the opposite of what Congress intended when granting the Commission broad authority to reform business conduct.

It is perfectly reasonable to allow flexibility with regard to the manner of disclosure so long as the manner in question is “reasonably designed to allow the counterparty to assess” the information. Oral disclosures with regard to potentially complex issues of risk do not meet that test. Nor is it appropriate to allow oral disclosures of conflicts, which may permit the SBS Entity to present the information in a way that glosses over the magnitude or extent of those conflicts, at least until after the transaction is completed and fuller written disclosures are provided. On the other hand, various forms of written disclosure – whether in email or by way of electronic platforms, for example – should provide both for adequate and timely review on the part of the counterparty and a verifiable record of disclosure for the purposes of enforcement if they are provided well in advance of the transaction.

To sum up, the Commission should revise its proposal to ensure that disclosures are provided in writing at the earliest possible point in advance of the transaction. If, ignoring our strong recommendation, the Commission does not adopt these changes for all counterparties, it must at the very least adopt them for transactions with special entities. After all, a key component of any best interest standard should be full and fair disclosure of all material information, including information about conflicts of interest. As drafted, the Commission disclosure rules do not meet that standard.

c. Material Risks and Characteristics of the Security-Based Swap

Material Risks: The Commission’s proposal with regard to disclosure of material risks of security-based swaps is good as far as it goes, but it does not go far enough. Specifically, if these requirements are effectively implemented, counterparties should benefit from disclosures regarding the material factors that influence the day-to-day changes in valuation, the factors or events that might lead to significant losses, the sensitivities of the security-based swap to those factors and conditions, and the approximate magnitude of the gains or losses the security-based swap will experience under specified circumstances. Indeed, we specifically suggested that the CFTC incorporate several of these factors into its required scenario analysis in order to provide a better description of risks. We appreciate that the Commission has heeded that request and incorporated them here and has specified that the disclosures must be “particular” to the transaction at hand. However, because the Commission fails to require the full-fledged scenario analysis required under the CFTC proposal, SBS Entities may seek to take advantage of this gap by providing boilerplate disclosures that offer minimal benefit to counterparties.

Moreover, the Commission proposal fails to clearly require disclosure of other issues, with regard to liquidity, for example, that clearly constitute material risks of swaps. While the Commission discusses liquidity risk in the test of the proposing Release, it does not include it on the list of factors SBS Entities would be required to disclose. Similarly, the Release directs SBS Entities to “consider the unique risks and characteristics associated with a particular security-based swap, class of security-based swap or trading venue, and tailor their disclosures accordingly.” It also directs the SBS Entity to consider “risks that may be associated specifically with uncleared security-based swaps,” such as the absence of a credit support agreement. However, none of these issues are addressed in the proposed rule itself, even by category. In order to ensure that the rule is implemented in a way that is consistent with apparent Commission

intent, the Commission should clarify and expand the rule proposal to address these gaps. It may also be appropriate for the Commission to provide additional guidance at the time the rule is finalized. Absent that greater clarity, the Commission may find it difficult to enforce the disclosure requirements in a manner that promotes robust disclosure.

Furthermore, for risk disclosures to be effective, they must be designed to enable the counterparty to assess relative risks and costs. This is particularly important for recommendations of customized swaps. For example, because of the higher fees they are able to charge, dealers have an incentive to recommend hedges that are customized to be very precise. That degree of customization, however, is also likely to make the swap highly illiquid. For many counterparties, the risk adjusted cost of a conventional, listed hedge equivalent may be much lower. In such instances, taking on some basis risk may make more sense than taking on the illiquidity risk of a less traded swap, particularly considering the relative costs. In order to highlight such risks, the rules should explicitly require swap dealers and major swap participants that recommend customized swaps to show the alternative and provide an assessment of the relative risks and costs of the two approaches. Requiring such disclosures would have the added benefit of helping to ensure compliance with proposed suitability and best interest standards where the incentive for non-compliance is greatest.

Material Characteristics: The Commission proposal also fails to provide any guidance with regard to material characteristics beyond material risks that would have to be disclosed. This is a significant oversight. One area in need of improved disclosure involves customized swaps that are simply amalgamations of standardized swaps or combinations of standardized swaps and other non-swap components, such as a loan. Such amalgamations make it possible for dealers to avoid the price transparency that comes with trading standardized swaps on swap execution facilities. To combat this practice, which both increases prices to customers and subverts the goal of the reform legislation, the required disclosure of material characteristics should detail, and separately price, the standardized component parts of any customized swap. This should include any imbedded credit for forgone collateral.

Such disclosures would better enable the counterparty and the swap dealer or major swap participant alike to determine whether the counterparty would be better served by a strategy using standardized components, a necessary aspect of determining suitability or best interest. Requiring such disclosures would also help to deter industry efforts to evade exchange trading and clearing requirements through the development of complex customized swaps that provide no added utility to the end user and may indeed cost that end user considerably more than they would pay to achieve the same result with standardized components.

In addition, the Commission should further clarify that disclosures should clearly identify any features of the swap that could disadvantage the counterparty. We are thinking specifically of such features as the interest rate mismatch embedded in the Jefferson County swaps, which left them making higher interest payments to J.P. Morgan than they were receiving from bond holders, as well as penalties that left them exposed to risks much greater than the county could reasonably afford to take. Ideally, such practices would be eliminated outright, at least with regard to special entities, through strong business conduct standards. But all counterparties, and the overall integrity of the market, would benefit from clearer disclosure that elucidate any swap

features that are designed to benefit the swap dealer or major swap participant at the expense of the end user. This could be accomplished through disclosures of material characteristics in some instances and through disclosure of conflicts of interest in others.

Master Agreements: The Commission requests comment on whether entry into a master agreement and provision of a trade acknowledgement would satisfy the disclosure obligation. We strongly oppose this approach, which is highly unlikely to produce the explanatory disclosures necessary to truly elucidate key issues related to risks and characteristics of the swap. Instead, under such an approach, key information could be lost in the fine print of legal documents. As we noted above, the complexity and opacity of these transactions demands that disclosures be made in an accessible form. This approach would not meet that standard. Indeed, if the current master agreement disclosures were sufficient, Congress would presumably not have felt it necessary to call for enhanced disclosures. If the Commission were to pursue this approach, over our strong opposition, it would at the very least need to take steps to ensure that the disclosures with regard to material risks and characteristics (as well as conflicts of interest and incentives) were discussed in a clearly labeled separate narrative incorporated into the overall document and that all key issues were disclosed pre-transaction and not in a post-trade acknowledgement.

Proprietary Information: The Commission requests comment on whether its proposed disclosure requirements might require disclosure of proprietary information. Such complaints from industry often serve as a smokescreen to cover more general opposition to increased transparency. The Commission should therefore take any such claims with a grain of salt, carefully distinguishing between those that raise genuine concerns and those that do not. Moreover, if the choice is between requiring disclosure of proprietary information and providing adequate warning of risks or other information necessary to enable a counterparty to assess the swap, we would hope that the Commission would not dismiss out of hand the notion that disclosure might take precedence. After all, disclosures in the context of a bilateral transaction would not need to broadcast any proprietary information beyond the parties to the transaction, for whom it is directly relevant.

d. Material Incentives or Conflicts of Interest

On the crucial issue of conflict of interest disclosure, the Commission proposes to adopt the narrowest possible interpretation of the material incentives and conflicts of interest that SBS Entities would be required to disclose. In particular, the Commission proposes to exclude what in many instances is likely to be the largest conflict – the differential compensation that SBS Entities receive when they recommend swaps. This would include the increased compensation they might receive for recommending a customized swap over a comparable exchange-traded alternative or recommending a swap rather than a non-swap alternative. As Bookstaber noted in his Senate testimony:

“For the bank, the more complex and custom-made the instrument, the greater the chance the bank can price in a profit, for the simple reason that investors will not be able to

readily determine its fair value. And if the bank creates a customized product, then it can also charge a higher spread when an investor comes back to trade out of the product.”¹⁹

To be effective, then, the conflict disclosures must be designed to elucidate and counteract pervasive incentives such as these to use complexity and customization to increase profits at the expense of end users. Disclosures that compare the risks and costs of customized swaps with those of standardized, listed swaps would be particularly helpful in this regard. It is frankly inexcusable that the Commission proposal fails to address this most fundamental of conflicts.

While not perfect, the CFTC proposal at least makes clear that swaps dealers and major swaps participants that recommend a swap “would be expected to disclose whether their compensation related to the recommended swap would be greater than for another instrument with similar economic terms offered by the swap dealer or major swap participant.” In commenting on the CFTC proposal, we urged the agency to take this required disclosure a step further. Specifically, we urged the agency to clarify that the disclosure would have to relate not just to a specific alternative instrument but to an alternative strategy, particularly where the recommendation involves a customized swap that is an amalgamation of standardized components. That should be the model for the SEC as well.

One area where both proposals need to be strengthened is in requiring more detailed disclosure of components that make up the price of a transaction. We urge the Commission to require more detailed pricing disclosure, which is both a material characteristic of the swap and, depending on how it is structured, may also constitute a material incentive to recommend a customized rather than a standardized swap. Among other things, these disclosures should require clear, separate pricing of any imbedded credit for forgone collateral.

In addition, both proposals entirely ignore the types of conflicts of interest that came to light in both the Senate Permanent Subcommittee hearings and in the SEC’s case against Goldman Sachs. As just one example, the SEC and CFTC should require clear disclosures related to the particular conflicts that exist when the swap dealer or major swap participant is trying to move a position off its books and the swap it is recommending is part of its strategy to do so. Rather than try to enumerate all the types of such conflicts that could exist and require disclosure, the Commission should make clear that swap dealers and major swap participants must disclose (and not just in boilerplate language) the full range of conflicts and incentives they have relevant and particular to a specific recommended transaction, including conflicts and incentives that relate not to specific payments but to their overall trading strategy, for example.

e. Clearing Rights

We strongly support the proposal to require disclosure of clearing rights and believe the framework the Commission has proposed for providing those disclosures is an appropriate one. A major goal of the derivatives title of Dodd-Frank is to encourage central clearing of swaps wherever possible. The required disclosures will support that goal. Where the swap in question is required to be cleared, the required disclosures would help to ensure that counterparties are aware of and have an opportunity to exercise their right to select the clearing agency. More

¹⁹ Ibid.

importantly, where the swaps are accepted for clearing but not required to be cleared, the proposed disclosures would help ensure that counterparties are aware of the availability of clearing. Moreover, whether the transaction is subject to central clearing would arguably be a material characteristic of the swap that ought to be disclosed. The required disclosures would therefore impose little if any additional regulatory burden, since SBS Entities would have to know for their own compliance purposes whether the clearing requirement would apply. Including information about clearing availability in separately required pre-transaction disclosures ought therefore to be a simple matter. To the degree that there is any added burden, permitting the counterparty to elect where to clear its swaps on an asset-class-by-asset-class basis or for all potential transactions would allow for streamlined compliance in these circumstances. If this approach is adopted, we believe it would be appropriate to require that these instructions be reaffirmed on at least an annual basis.

3. Know Your Counterparty

“Know your counterparty” requirements are an essential component of an effective business conduct rule regime. We therefore support the Commission’s proposal to adopt such a standard. Typically, we think of “know your customer” rules as the first component of a suitability or fiduciary standard. In its proposal, however, the Commission has decoupled the “know your counterparty” rule from the standards governing recommendations by SBS Dealers and acting as an advisor to special entities. Each of those separate provisions of the rule proposal includes additional components of a “know your counterparty” rule. (Following the Commission’s organizational lead, we will deal with those provisions within the context of the relevant sections rather than doing so here.) As a result, what remains in this category of the rule proposal is a much scaled down version of “know your counterparty.” Even acknowledging that this section does not represent the proposal’s last work on the topic, the rule proposal is weaker than that put forward by the CFTC. It does not apply to Major SBS Participants, and it does not include language requiring the SBS Entity to “use reasonable due diligence” to obtain the relevant information.²⁰

Given how the Commission has decoupled its “know your counterparty” requirement from any association with making recommendations or offering advice, it is frankly bewildering that the Commission has chosen not to apply at least certain of these requirements to Major SBS Participants. Specifically, we believe all SBS Entities should, at a minimum, be required to use reasonable due diligence to obtain and retain a record of: (i) facts necessary to comply with applicable laws, regulations and rules as well as (ii) facts necessary to effectuate the SBS Entity’s credit and operational risk management policies in connection with transactions entered into with such counterparty.

4. Recommendations by SBS Dealers

We strongly support imposing a suitability obligation on SBS Dealers when they make recommendations in connection with a security-based swap or a trading strategy involving

²⁰ On the other hand, requirements contained in the CFTC proposal to “evaluate the previous swaps experience, financial wherewithal and flexibility, trading objectives and purposes of the counterparty,” can be dealt with in the sections related to making recommendations and acting as an advisor.

security-based swaps. Unfortunately, the approach proposed by the Commission offers the promise, but not the reality, of a broad suitability standard. Instead of offering an alternative method of compliance that renders the standard meaningless, the Commission should address industry concerns about the scope of the obligation by tweaking the definition of recommendation to which it applies and providing further guidance on when the obligation would be triggered. (We discuss this approach in detail in the section on special entities.)

As the Commission notes in its proposing Release, “the obligation to make only suitable recommendations is a core business conduct requirement” for broker-dealers and other market professionals. Imposing a suitability obligation on swap recommendations is also directly responsive to the concerns raised by members of Congress, many of whom expressed shock at the degree to which investment banks had been willing to subvert the interests of their customers in order to maximize their own profits. Supplementing disclosure requirements with an obligation to make only suitable recommendations has the potential to greatly ameliorate this problem. Properly implemented, it should also help to prevent dealers from recommending swaps to counterparties who are using swaps to hedge risks that expose them to risks greater than those they are attempting to hedge.

The industry has traditionally argued against imposing suitability obligations in markets such as these on the grounds that institutional investors are capable of looking out for their own interests and have the resources to absorb any potential losses. As described in greater detail in the Background section of this letter, the history of the derivatives market is replete with examples that show this to be a myth. The complexity and opacity of many structured finance products has made them impenetrable to all but the most sophisticated industry experts. Indeed, even the non-experts within the financial firms themselves have not always understood the risks they entail. Unfortunately, that misconception about institutional investors’ ability to fend for themselves is reflected in the Commission’s proposal, which includes an alternative method of satisfying the suitability standard that relies on the same formulation. Unless this aspect of the proposal is fixed, the benefits of the suitability standard are likely to be theoretical rather than real.

Making a Recommendation: The Commission appropriately limits the proposal to situations in which the SBS dealer makes a recommendation. As a result, transactions in which the dealer acts purely as a counterparty would be exempt. We also support the Commission’s position that determination of whether a recommendation has been made “should turn on the facts and circumstances of the particular situation,” and we strongly agree that, “The more individually tailored the communication to a specific customer or a targeted group of customers ... the greater the likelihood that the communication may be viewed as a ‘recommendation.’” This last point has a special relevance in the context of swaps, where many of the products are customized. Customization by its very nature implies that the swap has been designed with the particular needs of the counterparty in mind. As a result, a suitability analysis should be required for any customized swap where the dealer plays a role in designing the customization. In such circumstances, it is not enough that the dealer determine whether the customized swap might theoretically be suitable for some counterparty; it should be required to determine whether the swap is suitable for that particular counterparty.

Reasonable Diligence: We agree that “what constitutes reasonable diligence” will vary, and that “the complexity of and risks associated with” the security-based swap or trading strategy are important facts that would influence that determination. Unfortunately, the Commission proposal appears to stop well short of requiring a full suitability analysis with regard to the counterparty. It requires the SBS Dealer to obtain relevant information regarding the counterparty’s “investment profile, trading objectives, and its ability to absorb potential losses associated with the recommended security-based swap or trading strategy.” Unlike the CFTC proposal, however, it does not propose to require the dealer “to obtain information through reasonable due diligence concerning the counterparty’s financial situation and needs, objectives, tax status, ability to evaluate the recommendation, liquidity needs, risk tolerance” or other relevant information. Nor does it require, as the CFTC proposes in the context of its “know your counterparty” rule, to require the swap dealer to “evaluate the previous swaps experience, financial wherewithal and flexibility, trading objectives and purposes of the counterparty.” Finally, neither the SEC nor the CFTC proposal explicitly requires that the information gathered be sufficient to enable the swap dealer to make the suitability assessment, and neither imposes documentation requirements sufficient to ensure that regulators can effectively enforce compliance.

Alternative Compliance Method: Unfortunately, the Commission and CFTC have both proposed to include an alternative compliance method that threatens to take away with one hand what it has given with the other. Specifically, the Commission proposal would exempt SBS dealers from the suitability standard in circumstances where the dealer determines “that the counterparty, or an agent to which the counterparty has delegated decision-making authority, is capable of independently evaluating investment risks with regard to the relevant security-based swap or trading strategy involving a security-based swap,” the counterparty indicates it is exercising independent judgment, and the SBS dealer discloses that it is not undertaking to assess the suitability of the transaction or trading strategy. Under these circumstances, the SBS dealer wouldn’t even have to have a reasonable basis to believe the swap was suitable for anyone, let alone for the particular counterparty to the transaction. In its proposal, the CFTC would at least require that the dealer or major swap participant have a reasonable basis to believe the counterparty has the capacity to absorb potential losses related to the swap or swap trading strategy, which might help to curb the worst abuses. If, over our strong opposition, the Commission retains this alternative compliance method it ought at the very least to include this added condition for reliance on that method.

In assessing this proposed approach, which we strongly oppose, it is important to keep in mind that what is at stake is not the SBS Dealer’s ability to enter into such transactions as a counterparty, but rather its ability to recommend such transactions. What is the benefit of permitting unsuitable recommendations – indeed recommendations that may not be appropriate for any counterparty – that justifies this approach? This approach, moreover, is likely to become the primary means of “complying” with the suitability obligation. Given the profits at stake, SBS Dealers will have strong incentives to conclude that the counterparty is capable of evaluating the transaction. Counterparties who turn to the derivatives markets out of questionable motives will have equally strong incentives to assert their capacity to independently evaluate investment risk. And even those with purer motives may be reluctant to confess to a lack of expertise. We have no doubt, for example, that the Orange County, California Treasurer

who bankrupted the county with his interest rate swap strategy in the early 1990s would have declared his competence to assess the risks. Indeed, we expect that would be true of many of those that Goldman duped into buying toxic mortgage-related swaps in the years leading up to the financial crisis – at least it would have been before the transactions blew up in their faces. Ultimately, if this approach is adopted, SBS dealers are likely to make such agreements a condition of doing business, rendering the suitability standard meaningless.

Reliance on Written Representations: This bad policy is made worse by the Commission’s proposal to allow SBS dealers to comply by relying on written representations from the counterparty. As we noted in our comments to the CFTC, “It is one thing to suggest that the swap dealer or major swap participant could rely on counterparty representations with regard to the facts on which the suitability analysis is based. It is quite another to suggest that they can rely on counterparty representations that the transaction itself is suitable.” The CFTC has at least proposed a decent standard for relying on written representations. The Commission has actually proposed as one alternative a standard that would allow reliance on representations without further inquiry except where the SBS Dealer affirmatively knows the representation to be false. Even its second alternative proposal wouldn’t require the SBS Dealer to have a reasonable basis for believing the representation to be true. Under the Commission’s proposed alternative method for complying with suitability, the only factor that might remotely serve as a check on dealers’ ability to take advantage of unsophisticated counterparties is a requirement that they be accountable for determining the counterparty’s capacity to assess the swap and its risks. While this is a slender reed on which to rest the standard, the Commission’s approach removes even this minimal protection. And all of this is being proposed in order to make it easier for dealers to recommend swaps that are not suitable for the counterparty, subverting the very reason that Congress chose to include broad business conduct rule authority in the Act.

Exceptions: The Commission does not propose to apply the suitability standard to Major SBS Participants on the assumption that they will not be engaged in the kind of dealer role that would make it appropriate. While this may be a reasonable assumption, it is just an assumption. A cleaner approach would be to apply the suitability standard to all SBS Entities. If they don’t engage in the conduct that triggers the standard, it will not apply. This approach avoids creating differential treatment based on regulatory status that may not be justified or, if it is currently valid, could cease to be justified as the industry evolves. As the Commission has reason to know all too well, such disparities can be difficult to repair once they are adopted as regulatory policy.

On the other hand, we agree that suitability obligations need not apply to recommendations made to other SBS Entities. Unlike other counterparties, these entities are actually likely to have the sophistication necessary to make their own independent evaluations of the swaps and their risks. We would strongly oppose any additional exemptions, however, for recommendations to broker-dealers or other market intermediaries who are not SBS Entities. There is no guarantee that such entities would have the specialized knowledge and sophistication to evaluate securities-based swaps, and there is no greater utility in permitting unsuitable recommendations that would justify the risks of such an approach. By the same token, we strongly oppose the approach the Commission requests comment on to further weaken these already fatally flawed rules by limiting them to retail investors, for the reasons described above.

We agree, at least in theory, with the Commission's view that compliance with the provisions governing acting as an advisor to a special entity ought to satisfy compliance with the suitability standard. Unfortunately, those provisions are so flawed that they do not achieve even a basic suitability standard, let alone the best interest standard intended by Congress when it drafted this section of the legislation.

5. Fair and Balanced Communication

We strongly support the Commission's proposed approach with regard to SBS Entities' communications with counterparties. In particular, we believe the three more specific standards the Commission has added to the broad principles-based requirement provide useful additional clarity to the standard without limiting its scope. We do not believe any further specific elucidation of those standards is necessary at this time. As the law is implemented, the Commission may identify specific practices that require either additional guidance or clarification through rules. As a general matter, however, we believe this is an area where adoption of enforceable, principles-based standards, as outlined in the proposing release, is likely to serve better than prescriptive rules.

We do not support providing exceptions to the requirement to communicate in a fair and balanced manner. Such exceptions could serve no beneficial purpose and would simply serve to make the standard less enforceable. While industry may be expected to argue that the requirement could discourage communication, discouraging unfair and unbalanced communication should be viewed as a benefit of the proposal not a shortcoming. As the hearings of the Senate Permanent Subcommittee on Investigations made clear, derivatives dealers have been all too willing to aggressively promote transactions they knew to be harmful to their customers' interests. It was precisely to stop such practices that this section of the legislation was drafted, and it should not be weakened.

6. Obligation Regarding Diligent Supervision

Drawing effectively from existing Exchange Act and SRO standards, the Commission has proposed a sound set of rules with regard to supervision. Importantly, the Commission recognizes that these rules set minimum standards, and that the list of requirements they impose would not be exhaustive. In addition, the documentation requirements should help to enable effective enforcement. We are concerned, however, that the proposed approach does not do enough to ensure that compliance with the supervisory procedures results in effective supervision. We believe two changes are needed to rectify this shortcoming in the existing standard. First, supervisory personnel should be required to report to upper management or the board, as appropriate, if they have reason to believe the supervisory procedures are not proving effective in preventing violations. In certain such circumstances, they may need to go beyond those procedures in order to provide effective oversight. Second, where supervisory procedures fail to detect or deter significant violations, the SBS Entity should be required to reevaluate those procedures to determine whether revisions are needed. Finally, we believe the Commission should apply the requirements to Major SBS Participants as well as to SBS Dealers. The goal of the provisions – to ensure compliance with the laws and regulations – is relevant in both business models.

D. Proposed Rules Applicable to Dealings with Special Entities

Prompted in part by revelations of the Senate Permanent Subcommittee hearings and in part by the plight of local governments struggling with skyrocketing payments on interest rate swaps sold them by major swaps dealers, Congress sought to provide added protections for a subset of counterparties dubbed “special entities.” Although the financial sophistication of these special entities varies greatly, they were generally considered to be less sophisticated than other participants in the swap market, such as hedge funds or major corporate users of swaps. In addition, these organizations – whether government entities, pension funds, or endowments – have individuals behind them who stand to suffer significant harm if the entity enters transactions that entail unacceptable and inappropriate risks. Using the Investment Advisers Act as a general model, Congress sought to ensure that swap dealers would act in the best interest of these more vulnerable counterparties when providing advice and making recommendations.

As we noted above, the first proposal Congress put on the table in this area would have imposed a strict fiduciary duty on all transactions between special entities and swaps dealers or major swap participants. While members ultimately realized that this approach would be unworkable, it provides an important context for evaluating proposals to implement the legislation. In particular, it demonstrates that congressional intent was to provide the strongest possible protection for special entities without adopting an approach that would preclude their participation in the swaps market. Clearly, Congress’s goal was to fundamentally transform the way in which market participants interact with these special entities.

Unfortunately, the Commission has proposed rules in this area that, far from fulfilling that congressional intent, would provide no meaningful new protections to these most vulnerable of market participants. First, the Commission includes an escape hatch in the definition of “acting as an advisor” that all but ensures the enhanced protections will never come into play. Moreover, one of the conditions of that provision – that the special entity rely on advice from an independent representative – uses a definition of independence that is so weak it would permit representatives to qualify as independent who are entirely financially beholden to SBS Entities. Unless the Commission radically alters this approach, special entities are likely to be required by SBS Entities to sign away their right to recommendations in their best interest as a condition of doing business, and there is no guarantee that the advice they get from their “independent” representatives will be any more disinterested. Finally, these standards incorporate an approach to reliance on written representation that is completely inadequate. In short, these provisions represent a complete betrayal of what Congress sought to achieve in adopting enhanced protections for special entities that participate in the swaps market.

Application of the Requirements: The legislation specifies that the enhanced protections for special entities would not apply to a transaction that is initiated by a special entity on an exchange or SEF and where the entity does not know the identity of the counterparty to the transaction. Noting that it may not always be possible to identify which party has initiated a transaction, the Commission proposes to exempt any transaction between a special entity and an SBS Entity on a SEF or an exchange where the SBS Entity does not know the identity of its counterparty. We believe this is a reasonable approach which is consistent with congressional

intent that the enhanced protections apply to transactions where there is a degree of reliance by the special entity on the dealer or major swaps participant.

1. Scope of the Definition of “Special Entity”

We believe the definition of special entity in the statute is reasonably straightforward and should not require extensive clarification. To the degree that the Commission is called upon to provide additional guidance, it should do so consistent with the principals that led to the development of this category. Many though certainly not all of the entities in this category lack financial sophistication. The typical example here would be the municipalities and school districts who suffered devastating losses on interest rate swaps they bought to hedge their interest rate risks. Many though not all also lack the resources to hire highly sophisticated financial advisers or to withstand potential losses on swaps transactions. This might include pension plans and endowments, for example. And all have individuals behind them – whether taxpayers or workers or others – who would be likely to suffer significant financial harm if the entity were taken advantage of by more sophisticated market participants. Although some chafe at being included in this category, this third criterion holds true for even the largest government pension plans, as the recent financial crisis made all too clear. When deciding issues of who fits within the category, the Commission should err on the side of inclusion in any situation where the entity shares these basic characteristics.

One specific definitional area where we believe we can offer insight into congressional intent involves the question regarding applicability to non-ERISA plans, such as government pensions. While the drafting of this section of the legislation is awkward, having been directly involved in negotiations over the language of this subsection, we have absolutely no doubt that Congress intended government plans to receive the same protections as others. Indeed, the taxpayers and government workers who stand behind government pensions are precisely the sort of constituents Congress sought to protect through the heightened protections for special entities. In order to keep these entities within the definition, committee staff engaged in extensive negotiations with representatives of government pensions in order to ensure that the legislation was drafted in a way that would be workable for them.

2. Best Interests

We do not believe it is necessary, or even appropriate, for the Commission to try to strictly define what is meant by “best interests.” It may, however, be appropriate for the Commission to provide guidance on how to apply the standard in particular circumstances. Having been directly involved in the negotiations over this language, we believe we can offer useful insight into congressional intent. First, Congress certainly did not intend to apply the ERISA fiduciary standard, with its strict limits on conflicts of interest, to these interactions. Indeed, members worked hard to ensure that the legislation did not have that effect. Instead, Congress’s model for the heightened standard that would apply to a swap dealer that acts as an advisor to a special entity is the Investment Advisers Act fiduciary duty. That is reflected in the statutory language, which is modeled on the provisions of the Advisers Act from which that law’s fiduciary duty flows. Consistent with that approach, Congress sought not to eliminate all conflicts of interest, but to ensure that conflicts would be appropriately managed and fully

disclosed (something the proposed disclosure requirements do not achieve). And they sought to ensure that the swap dealer would have a reasonable basis for believing its recommendations were in the best interest of the special entity, a standard they viewed as being higher than the suitability standard that has traditionally been applied to recommendations by brokers.

It is likely that issues that arise as the Commission seeks to determine precisely how to apply this standard would be similar in nature to issues that would arise from the imposition of a fiduciary duty on brokers when they give personalized investment advice to retail clients. If this is the case, it would certainly be appropriate to look to the approach to fiduciary duty outlined by the Commission in its Section 913 study as a model. While not every aspect of the application of the standards is likely to be identical, the basic principles outlined in the Section 913 study are appropriate – that the best interest standard is intended to provide protections that go beyond those of a suitability standard, that it is consistent with various different methods of compensation and with proprietary trades, but that it requires the full disclosure of any conflicts of interest. It is particularly important, in providing guidance in this area, that the Commission make clear that not all suitable recommendations would satisfy a best interest standard. Rather, as the term implies, the SBS Entity would be required to recommend from among the various suitable options the approach they believe to be best for the special entity.

We are disturbed by the statement in the “Advisor to Special Entities” section of the proposing Release that the best interest standard requires the SBS Dealer to provide suitable advice. This would seem to equate suitability and best interests in a way that is not consistent with the approach the Commission has adopted in other contexts, including its recent Section 913 study. It is one thing to suggest that a recommendation in the best interests of the special entity would satisfy a suitability standard, which is the message we hope the Commission intended to convey. It would be quite another to suggest that a recommendation that is suitable would automatically satisfy a best interest standard. If the latter is the intent of the comment, it would suggest that the Commission plans to adopt a completely inadequate approach to enforcing the best interest standard. Whether special entities receive the benefits of a best interest standard will depend in large part on how the Commission enforces that standard. It is essential that it do so in a way that imposes a heightened duty beyond mere suitability. Because the discussion in the Release is ambiguous on this point, we urge the Commission to clarify that this is its intent.

3. Advisor to Special Entities: Proposed Rules 15Fh-2(a) and 15Fh-4(b)

Where the rules go badly astray is in the definition of what it means to act as an advisor to a special entity. Accepting without question exaggerated industry claims of difficulties in applying this term, the Commission has proposed an approach that will not provide the heightened protections Congress intended for special entities and is likely to do little if anything to change the abusive practices targeted by the legislation. The primary flaw is not with the standards that would apply should an SBS Entity be deemed to be acting as an advisor, but rather that, under the approach proposed by the Commission, those standards are unlikely ever to apply. Adding insult to injury, the conditions the Commission proposes for permitting SBS Entities to make recommendations without triggering the best interest standard are completely inadequate, relying as they do on a definition of “independent representative” that does nothing to ensure that

these representatives are even remotely independent. As a result of these faulty definitions, the rule proposal which would otherwise be perfectly adequate is a sham, failing to provide any enhanced protections precisely where Congress intended that those protections be strongest.

In developing its proposal, the Commission has completely ignored congressional intent. There is no discussion in the proposing Release regarding the abuses that led Congress to adopt this provision or the best way of implementing the provision to ensure that it is effective in combatting those abuses. Instead, the entire discussion in the Release revolves around industry concerns, which are accepted without question. In fact, the industry arguments on which the Commission has based its proposal include a grain of truth amidst a load of exaggeration and misdirection. In letters to the Commission, for example, SIFMA and ISDA have argued that, without legal certainty about when they are acting as an adviser, swaps dealers will simply stop doing business with special entities. They have suggested that it may be “impractical” to meet a best interest standard when acting as a counterparty. And they have raised concerns that the standard could trigger regulation as a fiduciary under ERISA. (We discuss each of these issues in greater detail below along with the appropriate means of addressing any legitimate concerns they raise.) In crafting its proposal in response to those arguments, the Commission goes far beyond what would be necessary to address legitimate industry concerns and, in the process, neuters the standards.

Legal Certainty: We are sympathetic to industry arguments that defining acting as an advisor as making a recommendation does not provide SBS Dealers with enough legal certainty about what conduct would and would not trigger the definition. In revising the definition, the goal should be to clarify when the heightened protections would apply, not, as the Commission has done, to provide a mechanism for evading those protections entirely. The approach in the CFTC proposal offers a good starting point that, with a little tweaking and with additional guidance from the regulators, could address legitimate concerns about the need for greater legal certainty without gutting the rule in the process.

Like the Commission, the CFTC begins by defining the term “acting as an advisor” to mean making a recommendation. As we noted in our comment letter on the CFTC proposal, defining recommendations as advice is consistent not only with congressional intent but also with the approach that SIFMA and other industry groups have taken in suggesting a definition for personalized investment advice in commenting on the SEC’s Section 913 study. In that context, SIFMA proposed to define personalized investment advice as: as “investment recommendations that are made to meet the objectives or needs of a specific retail customer after taking into account the retail customer’s specific circumstances.” Adapted for the current purpose, an appropriate definition of advice might be: “recommendations related to a security-based swap or a security-based swap trading strategy that are made to meet the objectives or needs of a specific counterparty after taking into account the counterparty’s specific circumstances.” This refinement of the definition would draw a clearer line than the existing language and, as such, should provide greater legal certainty about when the heightened standards would apply.

The CFTC provides additional clarification in its proposed definition that the term does not include either providing general transaction, financial or market information to the special

entity or providing swap terms in response to a competitive bid request from the special entity. These are appropriate additions that ought to be included in the Commission definition. To the degree that additional clarification is needed to provide the legal certainty industry is demanding, the Commission should provide that clarification in the form of guidance at the time the rule is issued and as needed thereafter. One point the Commission should make clear in issuing that guidance is that customization, which by definition implies that the swap was designed with the particular needs of the counterparty in mind, would be included within the definition of acting as an advisor. The goal should be to limit customization to those circumstances in which it is suitable for the counterparty, under the institutional suitability standard, or in the best interests of the special entity, under the heightened best interest standard that would apply to transactions with special entities. Properly implemented, this approach would provide adequate legal certainty without gutting the rule.

In contrast, the Commission proposal provides legal certainty at the expense of heightened protections. It does so by creating a mechanism for SBS Dealers to escape the best interest standard when they are engaged in conduct to which it would otherwise apply. That alternative method of “compliance” with the best interest standard rests on completely inadequate conditions. The first and most important condition is that the special entity represent in writing that it will not rely on recommendations provided by the security-based swap dealer and that it will rely on advice from a qualified independent representative instead. First, in any transaction involving a customized swap, the special entity will by definition be relying on the swap dealer’s assertion that the customization was designed with the particular needs of the special entity in mind. If the swap dealer knows or has reason to believe that the customized swap is not in the best interests of the special entity, the dealer should be precluded from doing the transaction regardless of what representations the special entity provides about who it may be relying on. Second, as we will discuss in greater detail in the appropriate section below, the Commission proposal does nothing to ensure that the qualified independent representative is either qualified or independent. Under the circumstances, the required disclosures are just a way to protect the SBS Dealers from liability, not to protect the special entities from abuse.

Conflicts between Acting as an Advisor and Serving as a Counterparty: Industry commenters have also suggested that it may be “impractical” to meet the best interest standard when serving as a counterparty. If the Commission were to adopt the strict ERISA limitations on conflicts, or even the Advisers Act restrictions on principal trading, that might be the case. Neither was intended by Congress. The solution, however, is not to subvert congressional intent by providing a way for dealers to act as advisors without triggering the best interest standard. The solution is to interpret the best interest standard in a way that is consistent with the counterparty role and provide industry with guidance, as we have described in greater detail above. In this regard, it may be appropriate, as the Commission suggests in its request for comments, for the Commission to clarify “that it would not be inconsistent with an SBS Dealer’s duty to act in the best interests of the special entity of the SBS Dealer, as principal, were to earn a reasonable profit or fee from the transaction it enters into with the special entity.” The Commission certainly should not prohibit an SBS Dealer from acting as both an advisor and a counterparty to a special entity; that is something Congress specifically sought to avoid.

Possible Conflicts with the ERISA Fiduciary Definition: Congressional staffers involved in drafting this section of the legislation worked hard to ensure that it did not create an inappropriate conflict with ERISA. They were sensitive to the need not to bring ERISA's restrictions on conflicts to bear on a counterparty relationship where they would not be workable. DOL staff consulted by those congressional staffers assured them that there was not a conflict with the legislation. Certainly, DOL's proposed revisions to its fiduciary definition include a seller's exemption that is more than broad enough to accommodate this situation. Given the careful consideration that Congress gave to these issues, it is not appropriate for the Commission to undermine the business conduct rules in response to an industry argument that Congress specifically rejected. If there is a conflict, or a perceived conflict, between the two sets of rules, the solution is to clarify that through guidance or, if necessary, additional prohibited transaction exemptions under the DOL fiduciary definition. That can easily be accomplished without gutting the business conduct rules as the Commission proposes to do.

4. Counterparty to Special Entities: Proposed Rule 15Fh-5

Although Congress ultimately abandoned its original proposal to impose a fiduciary duty on all transactions between swaps entities and special entities, it did seek to ensure that special entities would be protected in any such transactions. It did so by requiring any swaps dealer or major swap participant who enters into or offers to enter a swap with a special entity to have a reasonable basis for believing the special entity has a qualified independent representative acting in its best interests to evaluate the transaction. This is a poorly written section of the statute, which creates the odd and somewhat awkward mechanism of making the swap dealer or major swap participant that is counterparty to a particular transaction responsible for verifying that the representative meets the established criteria. Even considering the problems with the statute, every aspect of the Commission proposal in this area is inadequate to fulfill congressional intent. The definition of qualified independent representative does nothing to ensure the representative is either qualified or independent. Nor is the rule adequate to ensure the independent representative is acting in the best interests of the special entity.

The Commission requests comments on whether the proposed rules should apply to all transactions with all special entities. We believe they should apply to all transactions other than anonymous transactions on an exchange or swap execution facility. By applying the requirement to offers to enter into transactions as well as to transactions that are entered into, Congress signaled its intent that the rules should apply broadly. However, it isn't reasonable to expect SBS Entities to verify information about a counterparty whose identity is unknown to them or unknown to them until the actual moment of the transaction. In addition, the rules governing acting as an advisor would supersede where the SBS Entity makes a recommendation to the special entity, as discussed above. In other words, these two separate provisions are designed to create a comprehensive set of business conduct standards with regard to transactions involving special entities where recommendations are covered by one set of protections and other traditional counterparty relationships are subject to a different approach.

a. Scope of Qualified Independent Representative Requirement

We strongly support the Commission's interpretation of the scope of the qualified independent representative requirement. As we have noted above, whether particular business conduct standards apply to Major SBS Participants as well as to SBS Dealers should be dictated by whether the Major SBS Participants are likely to be engaged in the conduct that is the subject of the standard. Since this is the case here, we agree with the Commission interpretation that the rules should apply equally to both types of SBS Entities. Furthermore, we believe the Commission's interpretation that the requirement should apply to security-based swap transactions with all special entities is the correct one and reflects congressional intent.

b. Independent Representative – Proposed Rule 15Fh-2(c)

The Commission proposal outlines a general standard for determining independence – that the “representative does not have a relationship with the SBS Entity, whether compensatory or otherwise, that reasonably could affect the independent judgment or decision-making of the representative.” Theoretically, this standard should provide for a generally appropriate level of independence. In the next clause, however, the Commission states that a representative would be deemed to be independent of an SBS Entity if two conditions are satisfied: (1) the representative is not and for the previous year has not been an associated person of the SBS Entity and (2) the representative has not received more than 10 percent of its gross revenues over the past year directly or indirectly from the SBS Entity.

In short, under the proposal put forward by the Commission, a representative would be deemed to be independent even if he or she worked with the SBS Entity as recently as a year ago, was recommended by the SBS Entity, has a direct business relationship with the SBS Entity that makes the representative highly financially dependent on that entity, and earns more of its revenues from the SBS Entity than from the special entity he or she purports to represent. Indeed, under this definition of independence, the representative could earn virtually all of its gross revenues from various SBS Entities, so long as no more than 10 percent comes from the entity on the other side of the transaction. This is a travesty. It is inexcusable that the Commission would present this as an acceptable definition of independence. It must be completely revised.

In contrast, the CFTC has proposed only one exception to the prohibition on “material business relationships” between swap entities and independent representatives of special entities. It clarifies that the term would not include “payment of fees by the swap dealer or major swap participant to the representative at the written direction of the Special Entity for services provided by the representative in connection with the swap executed between the Special Entity and the swap dealer or major swap participant.” In commenting on the CFTC proposal, we questioned the wisdom of allowing even these permitted payments without additional restrictions, since they could be used to hide the cost of the independent representative off the books of the special entity, creating a potential for abuse and conflict of interest of the sort the legislation is intended to prevent. In addition, in determining independence, the CFTC has proposed to permit the receipt of compensation from the swap dealer or major swap participant in the prior year, so long as it is disclosed to the special entity and the special entity agrees that it

does not create a material business relationship. In our letter, we encouraged the Commission to clarify that any such disclosure of prior compensation to the representative would have to be made to the board of the special entity, and that the written agreement that such payment does not constitute a material business relationship would have to come from the board.

We urge the Commission to adopt the CFTC approach with these minor adjustments. If the Commission feels it is necessary to provide additional clarification on what constitutes a material business relationship, it should adopt a standard consistent with that used by the Department of Labor's prohibited transaction exemption under ERISA that limits an independent fiduciary's annual income derived from or attributable to the party in interest and its affiliates to no more than one percent. This is consistent with the notion that the independent representative is intended to act in the best interests of the special entity. In addition, we would encourage both agencies to adopt a look-back period for the independence standards of at least two years. Under no condition should the Commission adopt an approach that would permit special entities to consent to additional conflicts of interest – an approach that would encourage collusion and evasion of the standards.

The Commission is correct in interpreting that Congress intended the representative to be independent of the swap dealer or major swap participant, rather than independent of the special entity. Having been involved in the negotiations over this section of the bill, we are aware that this issue was heavily discussed and that the clear intention was to allow internal employees of the special entity or others affiliated with the special entity to serve this function.

c. Reasonable Basis To Believe the Qualifications of the Independent Representative

We generally concur with the Commission proposal to allow SBS Entities to rely on written representations to determine that the representative is qualified. As discussed above, we do not support either of the two alternative standards the Commission proposes for relying on written representations without conducting an additional inquiry, but we are less concerned about that in this context than we are with regard to other aspects of the rule. That is because putting too much authority in the hands of the swap dealer or major swap participant to determine the qualifications of the independent representative could have the unintended consequence of undermining the ability of the representative to make an independent judgment on issues where the potential conflict with the swap dealer or major swap participant is greatest.

The Commission requests comment on a variety of issues related to implementation of this provision. We offer the following responses with regard to a few of those issues:

- *Qualification:* The Commission requests comment on whether it should consider development of a proficiency examination for independent representatives. This is an idea that we believe has promise, since it would provide a measure of expertise that wouldn't be subject to influence by biased SBS Entities. We have not had an opportunity to think through all the possible implications of such an approach, but we do think it is one that deserves further consideration.
- *Statutory Disqualification:* We support the Commission's proposed approach.

- *Best Interests:* Requiring representatives to be regulated in some capacity that imposes a best interest standard would add teeth to this requirement. This is an area where it is particularly important that the SBS Entity not be the arbiter of what is in the special entity's best interests, a problem that this proposed approach would help to prevent. In the absence of a requirement, it would be appropriate to presume that a representative who is acting in a capacity that independently imposes a best interest standard (such as an investment adviser or ERISA fiduciary) would meet this requirement.
- *Disclosures:* We support the Commission interpretation that the disclosure requirement would cover material information and would encourage the Commission to clarify that this includes information about material conflicts of interest the independent representative is aware of regarding the SBS Entity that is counterparty to the transaction.
- *Fair Pricing:* We believe the independent representative should be required to disclose the basis on which it determines that a particular transaction is fairly priced. That documentation should have to be sufficiently detailed to enable a third party to evaluate that conclusion. This is particularly important if the Commission persists in permitting representatives with massive conflicts of interest to serve as supposedly independent representatives.
- *Pay to Play:* We support the addition of this requirement.

d. Disclosure of Capacity

We support this requirement. By elucidating the several and potentially conflicting roles an SBS Entity may be playing in a particular transaction, the disclosures could have the added benefit of highlighting potential conflicts of interest. Indeed, the disclosures should be designed to draw attention to any potential conflicts between those different roles. While we support the disclosure requirement in general, we believe the Commission should make clear that the functions provided (e.g., making a personalized recommendation) and not the disclosures themselves would serve as the last word in determining the SBS Entity's legal obligations. In other words, we oppose the Commission's proposed approach of allowing SBS Entities to disclose away their suitability and best interest obligations to counterparties and special entities. Moreover, we see no reason why the rule ought not to apply equally to Major SBS Participants if they act in more than one capacity with special entities. As we have discussed above, application of the rules to Major SBS Participants should be determined by their function and not their regulatory status.

5. *Prohibition on Certain Political Contributions by SBS Dealers: Proposed Rule 15F-6*

We strongly support the Commission proposal to adopt pay-to-play rules for SBS Dealers. Pay-to-play has no more place in the swap market than it does in the securities markets. This proposal would help to eliminate what would otherwise be a serious gap in protections. However, we do not believe the Commission should exempt Major SBS Participants from these

rules based on what may turn out to be a false “assumption” that they will not be engaged in the type of activity that would make them appropriate. The rules should follow the function rather than being based on the regulatory status of the entity absent an actual prohibition on the entity’s engaging in the conduct that would trigger the rules.

6. Chief Compliance Office: Proposed Rule 15k-1

We generally support the Commission proposal with regard to designation of a chief compliance officer. Overall, the Commission appears to have made good use of existing requirements in other contexts to develop an appropriate regulatory approach. We are concerned, however, that the Commission appears to give the Chief Compliance Officer relatively little authority to resolve and mitigate conflicts of interest that are likely to be the chief source of compliance problems. Instead, the Commission makes a point of noting that ultimate responsibility in this area would continue to reside with the business units that are subject to the conflicts. We would urge the Commission to strengthen provisions in this area. At the very least, the chief compliance officer should be required to highlight in its annual report any recommendations it made with regard to resolution or mitigation of conflicts of interest that were not adopted. The Commission should not permit reporting to a senior officer of the firm to substitute for reporting to the board, nor should it permit the compliance officer to qualify its report. On the other hand, suggestions to require the CCO to certify its report and to require the audit committee to review the report could be beneficial.

7. Consistency With CFTC Approach

As we have noted throughout these comments, the Commission has consistently taken a much weaker approach to its business conduct rules than has the CFTC. This is harmful not just because it threatens to leave participants in the security-based swap markets with completely inadequate protections, but also because it strengthens industry’s hand as it seeks to undermine the CFTC’s efforts. It is frankly inexcusable that the Commission has released such a weak rule proposal. While theoretically we believe the markets would benefit from greater uniformity between the approaches of the two agencies, this would only be true if the Commission were to radically revise its proposal to more closely resemble the CFTC proposal. Under no circumstances should the CFTC bow to pressure to take the SEC’s proposal as its model.

Beyond that general overall weakness in the Commission proposal, we were disappointed that the Commission completely failed to include execution standards comparable to those proposed by the CFTC. As we said when commenting on that agency’s proposal in this area:

“A leading goal of Congress in adopting the derivatives title of the Dodd-Frank Act was to move as much of the market in standardized swaps as possible to central clearinghouses and transparent exchanges. A central component of a well-functioning market is the best execution requirement. In §155.7 of the proposed rules, the Commission has proposed to require Commission registrants, with respect to any swap that is available for trading on a DCM or SEF, to execute the swap on terms that have a “reasonable relationship” to the best terms available. While this falls short of a full-scale best execution obligation, it represents a strong first step toward creating such a standard.

Moreover, the approach outlined by the Commission includes the flexibility necessary to allow it to evolve as the market becomes more fully developed. In the meantime, this approach would add significant benefits to end users. We strongly support the Commission recommendation that the obligation apply regardless of whether the transaction actually occurs on a DCM or SEF, thereby helping to ensure that end users who opt to engage in bilateral transactions also receive the benefits.

“Just as the best execution requirement in securities markets includes consideration of a variety of factors in addition to cost, requiring transactions to occur on terms that have a “reasonable relationship” to the best terms will be similarly flexible depending on the particular interests of the client. Indeed, it will be incumbent on regulators to ensure that this flexibility is not abused. It may be appropriate for the Commission to provide additional guidance in this area, particularly if it identifies patterns of weak or non-compliance. In keeping with our preference for enforceable principles-based regulations, however, we would as a general matter discourage an overly prescriptive, rules-based approach.”

We urge the Commission to incorporate this approach to its business conduct rules before those rules are finalized.

IV. Conclusion

When the Dodd-Frank Act was enacted, our organizations cheered its passage but warned that its effectiveness in delivering the promised reforms would depend in large part on regulators’ willingness to stand up to industry pressure and adopt tough and effective implementing regulations. Nowhere is that more important than in bringing long-overdue regulatory oversight to the over-the-counter derivatives markets. And nowhere are the costs of regulation more justified, given the enormous economic harm that has befallen users of these markets from abusive practices that have become commonplace. When swaps customers are paying tens of billions of dollars in hidden and excessive fees, money that could have gone to productive uses, the costs of requiring clear disclosure of costs, risks, and conflicts are more than justified. When swaps dealers routinely trap municipalities and other unsophisticated users in contracts that include onerous and unjustified termination clauses, the costs of imposing a suitability and best interest standard on SBS Dealers’ recommendations pales by comparison. And that doesn’t even include the multitrillion-dollar cost of a financial crisis in which security-based swaps played a key enabling role.

Instead of delivering the sweeping reforms promised by Dodd-Frank, the Commission has issued precisely the sort of timid, industry-friendly rules that landed us in the financial crisis. It is absolutely imperative that the Commission send the staff back to the drawing board to develop rules commensurate with the severity of the market abuses they are intended to address. Fortunately, the Commission has a good, if imperfect, model in the CFTC’s proposed rules to use as it undertakes that task. Using the CFTC proposal as a model, and incorporating the strengthening amendments we have outlined above, we urge you to demand that these changes are made before the rules are finalized. Anything less would be unacceptable.

Respectfully submitted,

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Director of Investor Protection
Consumer Federation of America

Marcus Stanley
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University of Maryland Center for
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cc: Chairman Mary Schapiro, Securities and Exchange Commission
Commissioner Luis Aguilar, Securities and Exchange Commission
Commissioner Troy Paredes, Securities and Exchange Commission
Commissioner Elisse Walter, Securities and Exchange Commission

Appendix A:

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Affairs Bureau/Dollars & Sense
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press

- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women’s Policy Research
- Krull & Company
- Laborers’ International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National People’s Action
- National Council of Women’s Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer’s for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Institute for College Access & Success
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group (PIRG)
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum

- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

Partial list of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers

- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Leadership Conference on Civil and Human Rights

- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- TICAS
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG