BETTER MARKETS
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August 29, 2011

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

Re: Business Conduct Standards for Securities-Based Swap Dealers and Major Securities-Based Swap Participants; File Number S7-25-11

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules ("Proposed Rules") of the Securities and Exchange Commission ("Commission"). The Proposed Rules would implement the business conduct standards applicable to securities-based swap dealers ("SBS Dealers") and major securities-based swap participants ("Major SBS Participants") (collectively, "SBS Entities"), in accordance with Section 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

INTRODUCTION

For years, derivatives market participants have been unrestrained by disclosure obligations or standards of care, and they have often used this unregulated environment to reap huge profits at the expense of their counterparties, including municipalities, businesses, and other market professionals. With grossly distorted compensation incentives, SBS Dealers have created ever more complex products ostensibly customized to meet client needs, but actually designed to be incomprehensible by anyone other than a derivatives expert.

Like the proverbial car salesman who understands that the real profit is in the "add-ons and extras" that are poorly understood by the customer, SBS Dealers and Major SBS Participants have been incentivized to make transactions as complicated and opaque as possible, deriving greater and greater gains from each layer.

As a result, the history of the derivatives markets is littered with financial disasters and scandals arising from transactions sold by dealers to clients who never knew or understood the ramifications of the complex financial instruments they were sold. From industrial companies like Proctor and Gamble and Metallgeselschaft to financial entities

[1] Better Markets, Inc. is a nonprofit organization that promotes the public in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

like AIG and Long-Term Capital Management, enormous sums have evaporated from the balance sheets of major businesses through these instruments. And the losses to governmental entities like Orange County, California; Jefferson County, Alabama; the State of Wisconsin Investment Board; the State of West Virginia; and the Denver school district have cost taxpayers tens of billions of dollars.

SUMMARY OF COMMENTS

With full knowledge of the many egregious abuses for years in this area, Congress gave the Commission very broad authority to implement the business conduct standards.[2] Unfortunately, the Proposed Rules fail to take full advantage of this authority in the two areas that are most critical in any effort to raise the standards of conduct in the SBS markets.

First, the disclosure obligations are too limited in terms of scope, form, and content. The disclosure provisions will lift the veil of complexity surrounding derivatives only if they require more complete, timely, and intelligible disclosure of all the risks, costs, and other material information relating to SBS transactions.

Second, the Proposed Rules fail to establish the best interest standard as the duty for SBS Entities when they are advising ***all*** counterparties, not just Special Entities. While the suitability and know-your-counterparty provisions in the Proposed Rules will offer some protections, they fall well short of what the Commission can and must do to truly safeguard counterparties from predatory behavior in the SBS markets. If an SBS Entity makes recommendations to counterparties or otherwise provides advice, then they should be subject to the best interest standard, as developed in the context of the fiduciary duty. This standard should not be reserved solely for Special Entities.

Uniform application of the stronger standard is highly appropriate based on the now widely accepted proposition that any market participants who dispense advice regarding investments must be required to put the interests of their clients above their own. The need for this higher standard is nowhere more compelling than in the SBS markets, by virtue of the unique risks and complexities they present. The Commission's failure to adopt this approach will allow an unacceptable level of exploitation to persist in the SBS markets for years to come.

Even the Proposed Rules that implement the best interest standard in favor of special entities, defined to include government agencies, municipalities, and pension funds ("Special Entities"), are laden with limitations and exemptions that are indefensible under the Dodd-Frank Act. For example, the Proposed Rules include a definition of advisory activities (which trigger the best interest standard) that is too narrow and inconsistent with the statutory directive. In addition, the Proposed Rules only apply the best interest standard to SBS Dealers, not Major SBS Participants. And, without any statutory basis, they create an exemption that would allow SBS Dealers to act as advisors without being subject to the best interest standard.

[2] Release at 42397.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

Compounding these problems, the Release includes alarmingly inaccurate statements that appear to equate the best interest standard with suitability. To address this issue, the Proposed Rules must include a strong and clear definition of the best interest standard, and the adopting release must correctly delineate the distinction between suitability and best interest.

Our specific comments on these and other elements of the Proposed Rules include the following:

- **The disclosure provisions in the Proposed Rules must be strengthened with respect to the parties entitled to disclosure, the timing and manner of disclosure, and the information disclosed.**
  - The disclosure obligations should apply even when the counterparty is also an SBS Entity.
  - Disclosure should be required at a reasonably sufficient time prior to the SBS transaction, in writing, and in a clear and intelligible format.
  - The Proposed Rules must require disclosure of additional content, including disaggregated prices and risks, listed hedge equivalents, scenario analysis, and embedded financing costs.
- **The Proposed Rules must apply the best interest standard, not merely a suitability test, whenever an SBS Entity acts as an adviser to a prospective counterparty.**
  - Imposing the best interest standard for all advisory activity, not just advisory activity directed to Special Entities, is consistent with the general principle that anyone who advises others about financial instruments should be subject to the fiduciary duty.
  - The applicable standard must be applied to both types of SBS Entities.
- **The Proposed Rules must be strengthened to better protect Special Entities.**
  - The Proposed Rules must define the "best interest" standard and the adopting release must dispel the implication that it is equivalent to a suitability standard.
  - Major SBS Participants should also be subject to the best interest standard if they act as advisors to Special Entities.
  - The Proposed Rules should expand the definition of "advisor" to cover more than just recommendations.

- The exemption from the definition of "advisor," applicable when independent representatives are involved, should be eliminated.

- The definition of "independent representatives" must be strengthened to eliminate conflicts of interest.

- The Proposed Rules must adopt the stronger standard for determining when an SBS Entity may no longer rely on information obtained from independent representatives and others.

- The Proposed Rules must require Major SBS Participants, as well as SBS Dealers, to disclose the capacity in which they are acting when they enter SBS transactions with Special Entities.

- The Proposed Rules must narrow the exemption from compliance with the Special Entity provisions in accordance with the statutory language.

- **The provisions in the Proposed Rules dealing with Chief Compliance Officers ("CCOs") should be enhanced with additional measures designed to ensure the effectiveness and independence of the CCO.**

  - The Proposed Rules should impose qualification standards on CCOs.

  - The Proposed Rules should provide for CCO oversight solely by independent board members.

  - The Proposed Rules should prohibit coercion or other interference with the CCO.

  - The Proposed Rules should require the board to review the CCO's annual report and either formally approve it or provide separate comment.

THE DODD-FRANK ACT AND THE PROPOSED RULES

The Dodd-Frank Act imposes three basic types of business conduct standards: Antifraud prohibitions, disclosure obligations, and standards of care focused specifically on the duties that SBS Entities owe when they trade with or advise Special Entities.

The Proposed Rules include provisions on all three of the major topics covered in the Dodd-Frank Act.[3] The Proposed Rules also incorporate some additional measures

[3] With respect to the antifraud provisions, the Proposed Rules include relatively few new standards applicable to SBS transactions. Instead, they rely largely on the fact that some of the antifraud provisions relating to business conduct in the Dodd-Frank Act are self-executing. In addition, the Proposed Rules confirm that they are not intended to limit or restrict the applicability of other provisions in the securities laws that already prohibit fraud in securities transactions or in the existing rules and regulations promulgated thereunder. Release at 42401.

authorized but not expressly required by the Dodd-Frank Act, including suitability and know-your-customer standards modeled on SRO rules, as well as pay-to-play provisions. Finally, the Proposed Rules would implement a separate section of the Dodd-Frank Act that establishes the duties of CCOs of SBS Entities.

COMMENTS ON PROPOSED RULES

The Disclosure Provisions in the Proposed Rules Must Be Strengthened With Respect to the Parties Entitled to Disclosure, the Timing and Manner of Disclosure, and the Information Disclosed.

The Dodd-Frank Act mandates that the Commission adopt rules requiring SBS Entities to disclose certain types of information to counterparties in SBS transactions, including information about the material risks and characteristics of SBS and the material incentives or conflicts of interest that an SBS Entity has in connection with an SBS transaction.[4]

Effective disclosure obligations are critically important to the creation of a fair and properly functioning SBS marketplace. Parties that seek to trade in these complex instruments must have the benefit of full disclosure of all the material terms and risks associated with SBS transactions, as well as the conflicts of interest and other incentives that are influencing SBS Entities in their dealings with counterparties. To ensure that the disclosure regime applicable to SBS transactions is adequate, the Proposed Rules must be strengthened in numerous important ways.

The Disclosure Obligations Should Apply Even When the Counterparty Is Also an SBS Entity.

The general disclosure requirements under the Proposed Rules would ***not*** apply whenever the counterparty is an SBS Entity, a swap dealer, or a major swap participant.[5] The Release explains that this approach is based primarily on the statutory language of the Dodd-Frank Act, which parenthetically exempts SBS Entities from the universe of counterparties that must receive disclosure.[6]

This narrow approach is unwarranted. All counterparties, including SBS Entities, should be entitled to the disclosures required under the Dodd-Frank Act. As a legal matter, the statute clearly does not prevent the Commission from extending the benefits of

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[4] The Release raises a threshold question as to whether the intended beneficiaries of the Proposed Rules should be permitted to opt out of the protections they receive. Release at 42402. Such an approach must be rejected. As suggested in the Release, many counterparties will not have a meaningful opportunity to assess whether or not they should opt out, and they will undoubtedly be pressured by some SBS Entities to make choices that are not in their best interest. An opt-out provision will only add confusion to an already complex regulatory framework and create opportunities for market participants to evade compliance with the much- needed business conduct standards. This will needlessly require the Commission to devote yet more to its limited resources to policing abuses under the opt-out clause.

[5] Release at 42405.

[6] *Id.* The Release also notes that, with respect to the "daily mark," the Commission believes that mandatory disclosure of this information to an SBS Entity would be unnecessary because it would be independently available. *Id.*

disclosure to SBS Entities; it simply does not require the Commission to do so. In addition, there is no rationale that supports such an exemption. In terms of access to information, a counterparty does not necessarily have access to all material information regarding the terms, risks, and conflicts of interest involved in an SBS transaction simply by virtue of being an SBS Entity.

Nor does the supposed sophistication of an SBS Entity justify depriving it of mandatory disclosures. First, of course, the levels of sophistication among SBS Entities vary widely, particularly among Major SBS Participants. Derivatives risk is often difficult to understand even for sophisticated financial professionals who are fully capable of handling more conventional investment products. Second, regardless of how sophisticated an SBS Entity may be, it will not necessarily have access to the information it needs to make informed decisions about SBS transactions.

A thorough understanding of the risks, costs, and conflicts associated with an SBS transaction is material information that all counterparties must have access to. Therefore, an SBS Entity should be entitled to the same information that any other counterparty receives under the business conduct standards.

An additional benefit of such an approach will be to create a uniform disclosure system, culture, and practice, not tied to who the counterparty happens to be or other factors. Such a uniform requirement will reduce costs, confusion, and mistakes, as well as exploitation of the less knowledgeable and experienced SBS Entities.

Disclosure Should Be Required at a Reasonably Sufficient Time Prior to the SBS Transaction, in Writing, and in a Clear and Intelligible Format.

The Dodd-Frank Act does not address the timing or manner of the required disclosures. The Proposed Rules fill these gaps to some degree, but they must go substantially further to ensure that the required disclosures are meaningful.

The Proposed Rules appropriately require that disclosure be made ***before*** an SBS transaction takes place.[7] This basic requirement is obviously essential to meaningful disclosure. However, the Proposed Rules should also require disclosure at a reasonably sufficient time prior to the transaction so that the counterparty has an opportunity to understand and evaluate the information provided.[8] Disclosure that is too late to be useful is tantamount to no disclosure at all.

With respect to the manner of disclosure, the Release explains that the Proposed Rules would afford parties significant "flexibility" and permit a wide range of communications, including telephone calls.[9] Where disclosure is not made in writing before the transaction, the Proposed Rules would only require that a contemporaneous

[7] Release at 42406.
[8] This is the approach adopted by the CFTC. CFTC Rule § 23.431.
[9] Release at 42406.

written record be made and provided to the counterparty no later than the trade acknowledgement.[10]

This approach is woefully inadequate and will invite needless errors and abuses. Allowing merely verbal disclosure prior to an SBS transaction, even with a subsequent written record, will substantially increase the risk that the disclosure will be erroneous, incomplete, unclear, or misunderstood. Moreover, it leaves far too much room for abuse, creating opportunities for unscrupulous SBS Entities to make partial or nonexistent disclosures without adequate proof of compliance. All of these problems can be mitigated with a simple and clear rule: all disclosures must be made in writing, either via documents or electronic transmissions.

Finally, to be comprehensible, all of the information subject to the disclosure requirements must be presented in clear terms, in a format that permits comparison between derivatives offered by different market participants, and without so much encumbering detail that recipients of the information are overwhelmed and confused. The Proposed Rules would simply require disclosures to be made "in a manner reasonably designed to allow the counterparty to assess" the risks, characteristics, and incentives associated with an SBS transaction.[11] This standard is not sufficiently prescriptive.

The Proposed Rules Must Require Disclosure of Additional Content, Including Disaggregated Prices and Risks, Listed Hedge Equivalents, Scenario Analysis, and Embedded Financing Costs.

The substance of the mandatory disclosures under the Proposed Rules must also be expanded. In their current form, the Proposed Rules largely track the general terms of the statutory language and they require disclosure of two basic categories of information: (1) the material risks and characteristics of the SBS, and (2) the material incentives or conflicts of interest that the SBS Entity may have in connection with the SBS.[12] With respect to each category, the Proposed Rules must require the disclosure of more specific information.

The risks and prices associated with complex transactions must be disclosed in terms of their disaggregated components. SBS Entities often recommend complex SBS with multiple embedded risks, marketing them as customized to meet the needs of the counterparty. These products typically can be disaggregated into separate constituent instruments, which are often available in more transparent markets. In disaggregated form, such complex SBS are much more easily understood.[13]

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10 *Id.*

11 *Id.*

12 Release at 42407-10.

13 The enormous complexity of derivatives transactions has been the subject of study by some leading economists. One analysis shows that derivatives generally are so complex that it may be impossible to price them accurately without unlimited computational power—a characteristic known as "computational intractability." *See* Sanjeev Arora, Boaz Barak, Markus Brunnermeier, and Rong Ge, *Computational Complexity and Information Asymmetry in Financial Products* (Working Paper) (Oct. 19, 2009), *available at* http://www.cs.princeton.edu/~rongge/derivative.pdf (incorporated herein as if fully set forth). This article observes that "designers of financial products can rely on computational intractability to disguise their information . . . . [and] can generate extra profits from this hidden information, far beyond what would be possible in a fully rationale setting." *Id.* at 1. As noted in the article, one potential remedy for this problem is

In fact, disclosure of the disaggregated components of an SBS transaction is the only way heterogeneous market participants will be able to compare SBS products on an apples-to-apples basis. It is a critical part of any disclosure regime, and it will significantly reduce bid and offer spreads and product costs borne by SBS customers in the future.

Moreover, without such disaggregated disclosure, it is difficult to see how anyone could determine if such an SBS would be suitable.[14] Meaningful disclosure in compliance with the directives of the Dodd-Frank Act must require readily understandable disaggregated data on each component of an SBS.

Therefore, the Proposed Rules must require SBS Entities to disclose derivatives risks and prices in disaggregated form so that counterparties can readily compare alternative transactions and relative risks.

Listed hedge equivalents must be provided to customers. Often, SBS counterparties are sold esoteric derivatives when conventional, listed instruments could address their risks almost as precisely as the more complex (and always more expensive) SBS transaction actually sold. The more esoteric a derivative is, the more difficult it is to understand both the derivative itself and its pricing. Not coincidentally, the more complex it is, the more profitable it is for the SBS Entity.

One anecdote captures the dominant role of complexity in the marketing and profitability of derivatives. The following question was recently asked privately of a very senior trader at a major hedge fund (who had worked at one of the top 5 investment banks for many years before his current position): If the compensation was the same for a plain vanilla swap as it was for a complex swap, what percentage of swaps would be complex swaps? Without a moment's hesitation, he said almost none.

To combat this contrived and profit-driven complexity in SBS transactions, the Proposed Rules must require SBS Entities to provide customers the hedge equivalent alternatives to constructed, esoteric transactions, along with appropriate information on price correlations.[15]

In addition, an evaluation of the relative liquidity of the proposed esoteric SBS and the listed hedge equivalent must be provided. The hedge equivalent may, for instance, be an imperfect hedge for the business risk that the customer is seeking to address through the SBS transaction. However, the more esoteric SBS, which is a marginally better hedge in one sense, may be highly illiquid. This illiquidity may well pose risks to the customer that are significantly worse than the sliver of risk left uncovered by the listed hedge equivalent.

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different product design, which would make derivatives less susceptible to seller manipulation. *Id.* at 11. Another remedy is improved disclosure.

[14] Similarly, disaggregation will greatly aid the transparency and the usefulness of post-trade data which is to be disseminated to the regulators and the public.

[15] This is directly related to the need for reported swap data to include hedge equivalent pricing for post-trade analysis by regulators and the public.

Finally, if the SBS Entity is not required to post margin to the counterparty under the esoteric SBS, the difference in potential credit exposure to the counterparty, relative to the listed hedge equivalent, must be described as well.

Only with all of this information in hand can a counterparty effectively evaluate whether the esoteric SBS, which is typically much more profitable for the SBS Entity but riskier than the conventional alternative, is suitable for the counterparty.

The Proposed Rules must require scenario analysis, and that analysis must include information on liquidity and volatility with respect to the proposed SBS. These factors, along with counterparty risk, are at the heart of the complexity and unique risks associated with derivatives. Disclosure of risks and projected scenarios are inadequate without consideration of these factors.

A fundamental reason that derivatives are difficult for counterparties to understand and evaluate is that many are traded in highly illiquid markets subject to great price volatility. Therefore, in both the disclosure and the scenario analyses, information concerning the liquidity and the volatility of the market for the SBS under consideration must be provided. Historical liquidity and volatility must be included in the disclosed information.

Guidance for the scenario analysis must be provided in the Proposed Rules. Liquidity is generally represented by an assumed holding period for liquidation of a position upon default. While DCOs often use holding periods of 3 days when calculating margin for listed and cleared SBS, in the scenario analysis required by the Proposed Rules, "worst case" scenarios of 5 and 10 days must be required.

Volatility is represented by the confidence interval. The scenario analysis, like the DCO initial margin calculation, is used to estimate levels of risk based on prudent assumptions. This is a higher standard than reasonably-expected trading profit or loss. The confidence interval must be 99 percent at a minimum. These more demanding parameters are essential to accurately assess the risks posed by illiquid and volatile SBS.

Where credit arrangements are built into SBS through forbearance of collateral posting, the embedded credit and its price must be disclosed separately from the SBS price. SBS Entities routinely enter into SBS under the condition that they will not require the counterparty to post margin or collateral, up to a cap. Contrary to what some market participants may believe (or have been lead to believe), there is a cost associated with the extension of credit represented by this forgone margin or collateral.[16]

[16] Professor John Parsons of MIT and Professor Antonio Mello of the University of Wisconsin have written extensively on the forborne derivatives collateral and the embedded loan. Some of these materials can be found at (and are incorporated herein as if fully set forth):
http://bettingthebusiness.com/2011/02/14/the-collateral-boogeyman-is-back/
http://bettingthebusiness.com/2010/10/25/otc-5-the-collateral-boogeyman-%E2%80%93-packaging-credit-implicitly-and-explicitly/
http://bettingthebusiness.com/2010/10/07/otc-3-the-collateral-boogeyman-%E2%80%93-the-delusion-of-%E2%80%9Cfree%E2%80%9D-credit-from-your-friendly-neighborhood-derivatives-dealer/

In the common practice of transacting derivatives bi-laterally, there is not one transaction, but two: an SBS and an extension of credit. If the dealer's counterparty does not understand this in detail, the transaction cannot be fully understood.

The Proposed Rules must address this issue by specifically requiring disclosure of the following information:

- The amount charged for the extension of credit.
- The method used by the SBS Entity to calculate the amount of credit extended, from time to time.
- The effect of the transaction on the capacity of the SBS Entity to extend incremental credit to the counterparty. [17]

These disclosures are also essential for purposes of suitability determinations. Embedded credit arrangements, and especially the provisions that require immediate cash funding of margin upon an event such as a credit rating downgrade, are an integral part of an SBS transaction. It is impossible to determine if an SBS is suitable unless such embedded transactions are included in the analysis.

The Proposed Rules Must Apply the Best Interest Standard, Not Merely a Suitability Test, Whenever an SBS Entity Acts as an Advisor to a Prospective Counterparty.

The Proposed Rules would generally require an SBS Dealer making recommendations to a counterparty to have a reasonable basis for believing that the recommended SBS or trading strategy is suitable for the counterparty.[18] The Dodd-Frank Act does not expressly address this general standard of conduct, and we therefore commend the Commission for proactively imposing an explicit duty of care on SBS Entities when they recommend SBS transactions to any type of potential counterparty. However, the chosen standard—modeled on the SRO suitability requirement—falls short of the level of care that should be applied in the SBS marketplace.

Imposing the Best Interest Standard for All Advisory Activity, Not Just Advisory Activity Directed to Special Entities, Is Consistent with the General Principle that Anyone Who Advises Others About Financial Instruments Should Be Subject to the Fiduciary Duty.

The decision to impose only a suitability standard on SBS Entities recommending transactions is inconsistent with the fundamental principle that ***any*** market participant that dispenses advice to others about investment products, regardless of their title or registration status, should be uniformly held to the fiduciary duty. That principle has

http://bettingthebusiness.com/2010/10/11/otc-4-the-collateral-boogeyman-%E2%80%93-lobbyists-trot-out-the-free-lunch/

[17] The separate pricing for post trade disclosure, addressed in other proposed rules, is an obvious boon for price transparency, and the same principles apply here. Furthermore, clarity of pricing will promote competitiveness, which will ultimately benefit the customers and the public.

[18] Release at 42415.

finally gained acceptance in the context of broker-dealers who advise retail investors about securities, and it is embodied in the Dodd-Frank Act provisions authorizing the Commission to promulgate rules imposing the fiduciary duty on such broker-dealers. The Commission must seize this opportunity to establish a stronger and better standard of care in the SBS marketplace as well.

The higher standard of care is nowhere more necessary than in the SBS markets. Given the complexities and risks inherent in SBS transactions, the only way to ensure fair treatment of counterparties is to go beyond mere suitability and require any SBS Entity making recommendations to observe the best interest standard, as it has evolved in the context of the fiduciary duty.

The Applicable Standard Must Be Applied to Both Types of SBS Entities.

Whatever standard the Commission determines to adopt, it should apply equally to Major SBS Participants as well as SBS Dealers. Major SBS Participants do in fact make recommendations regarding SBS transactions to counterparties, and there is no reason to exempt them from whatever standard of care governs recommendations and other advisory activity.[19] There is no justification for the more limited approach under the statutory language of the Dodd-Frank Act or its underlying policies. Market participants engaged in similar activity must be subjected to similar standards of conduct.

<u>The Proposed Rules Must Be Strengthened To Better Protect Special Entities.</u>

The Dodd-Frank Act imposes additional obligations on SBS Entities when they advise Special Entities or enter into SBS transactions with them. Special Entities are defined to include federal, state, or municipal agencies; employee benefit plans under ERISA; and endowment funds. Congress adopted these protections in light of the public nature of Special Entities, the widespread harm that financial exploitation of Special Entities can inflict, and their demonstrated vulnerability to abuse.

To adequately implement the special protections intended for Special Entities under the Dodd-Frank Act, the Proposed Rules must be significantly strengthened.

The Proposed Rules Must Define the "Best Interest" Standard and the Adopting Release Must Dispel the Implication that It Is Equivalent to a Suitability Standard.

The Dodd-Frank Act requires any SBS Entity that serves as an advisor to a Special Entity to act in the best interest of that Special Entity.[20] Further, the statute requires any SBS Entity that enters into an SBS transaction with a Special Entity to have a reasonable basis for believing that the Special Entity has its own independent representative, who will act in the best interest of the Special Entity.[21]

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[19] The CFTC rules adopt this broader approach with respect to the suitability standard. CFTC Rule § 23.434.
[20] Exchange Act § 15F(h)(2)(A) and § 15F(h)(4), as added by Dodd-Frank Act § 764(a).
[21] Exchange Act § 15F(h)(2)(B) and § 15F(h)(5), as added by Dodd-Frank Act § 764(a).

These provisions reveal an unmistakable Congressional intent to provide a strong layer of protection for Special Entities in their dealings with SBS Entities. To ensure that this standard is not diluted in its application, the Proposed Rules must include a definition of "best interest." That definition must be at least as strong as the concept of "best interest" as it has evolved under the fiduciary principles applicable to investment advisors.

A clear definition of "best interest" in the Proposed Rules is essential in light of multiple statements in the Release suggesting that the best interest standard which Congress adopted in Section 764 of the Dodd-Frank Act is tantamount to "***suitability***." For example, the Release states that "the Dodd-Frank Act effectively imposes a suitability requirement on SBS Dealers that, when acting as advisors, make recommendations to special entities."[22] Elsewhere, the Release describes the best interest standard as "heightened suitability requirement."[23]

There is ***no statutory or policy justification*** for these suggested interpretations of the "best interest" standard. Congress's choice of words was not haphazard or accidental. As noted above, Congress carefully and repeatedly adopted the best interest standard in the provisions of the Dodd-Frank Act designed to protect Special Entities from abusive practices in the SBS market. And Congress did so with full awareness of the weaker suitability standard, an SRO concept developed years ago for broker-dealers making securities recommendations.

The Commission's gloss on the best interest standard, reflected in the Release, is simply ***inconsistent with the statutory language*** of the Dodd-Frank Act and its underlying purposes. It is therefore essential to negate any inference that it would be acceptable to equate the best interest standard with suitability. To accomplish this goal, the Commission should not only define "best interest" as set forth above, it should also acknowledge in the adopting release that the best interest standard intended by Congress is a fiduciary concept that goes well beyond suitability.

Major SBS Participants Should Also Be Subject to the Best Interest Standard If They Act as Advisors to Special Entities.

The Proposed Rules would apply the best interest standard only to SBS Dealers that act as advisors to Special Entities. To ensure that the protections afforded to Special Entities are comprehensive, and to implement the plain language and intent of the Dodd-Frank Act, the Proposed Rules must also apply the best interest standard to any Major SBS Participant that acts as an advisor to a Special Entity.

The Dodd-Frank Act clearly states that—

> "A security-based swap dealer ***or*** major security-based swap participant that acts as an advisor to [a] special entity regarding a

[22] Release at 42400.
[23] Release at 42417.

> security-based swap shall comply with the requirements of paragraph (4) [which imposes the best interest standard] . . . ."[24]

This statutory language is significant for two reasons. First, it implicitly acknowledges that Major SBS Participants, as well as SBS Dealers, may act as advisors to Special Entities. Second, it plainly requires ***both*** SBS Dealers and Major SBS Participants to comply with the best interest standard, whenever they do act as advisors.

The statute creates some ambiguity since the clause in paragraph (4) that imposes the best interest standard refers only to SBS Dealers.[25] However, this ambiguity can and should be resolved in favor of affording broader, not narrower, protections for Special Entities. The best way to fulfill Congress's goal of protecting Special Entities is to subject Major SBS Participants as well as Dealers to the best interest standard if they step into the role of advisor to a Special Entity. There is no logical basis for subjecting Major SBS participants and SBS Dealers to different standards of conduct if they are engaged in the same activity, namely acting as advisors to Special Entities.

Applying the best interest standard to both types of SBS Entities is also consistent with the Commission's treatment of similar ambiguities in Section 764 of the Dodd-Frank Act. For example, the Dodd-Frank Act requires SBS Dealers who enter into SBS transactions with Special Entities to comply with provisions relating to independent representatives for Special Entities.[26] Even though part of the statutory language refers only to SBS Dealers, the Release explains that the Proposed Rules will apply those requirements to ***Major SBS Participants*** as well as Dealers, since the clause that details the independent representative obligations refers to both types of SBS Entities.[27]

This statutory ambiguity is similar to the one relating to the best interest standard: one provision references both types of SBS Entities, while a related provision on the same subject references only one type of SBS Entity. The Commission should resolve both in the same fashion, by requiring Dealers ***and*** Major SBS participants to afford enhanced protections to Special Entities when they act as advisors.

The Proposed Rules Should Expand the Definition of "Advisor" To Cover More than Just Recommendations.

The Proposed Rules would define "act[ing] as an advisor" to mean "recommend[ing] a security-based swap or a trading strategy that involves use of a security-based swap."[28] This definition is too narrow and must be expanded.

An "advisor" advises, and the plain meaning of the word "advise" is clearly broader than the word "recommend." The former encompasses not only specific recommendations,

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24 Exchange Act § 15F(h)(2)(A) and § 15F(h)(4), as added by Dodd-Frank Act § 764(a) (emphasis added).
25 Release at 42423 n. 196; Exchange Act § 15F(h)(4), as added by Dodd-Frank § 764(a).
26 Exchange Act § 15F(h)(2)(B) and § 15F(h)(5), as added by Dodd-Frank Act § 764(a).
27 Release at 42426.
28 Release at 42424.

but also more general information and opinions. Thus, the definition in the Proposed Rules is inconsistent with the broader statutory mandate.

Adopting such a narrow definition will also undermine the purposes of the Dodd-Frank Act. The Dodd-Frank Act was written to ensure that whenever SBS Entities act as advisors to Special Entities, those Special Entities receive additional protections against potential abuses. Those protections include not only the best interest standard, but also strong antifraud provisions as well. Limiting the definition of "advice" to recommendations will subject Special Entities to a wide range of advisory activities without the benefits of those additional protections.

It is easy to imagine scenarios in which an SBS Entity could provide a Special Entity with large amounts of data, analysis, and opinions that are recommendations in fact, but not labeled or characterized as such. All of that advice would undoubtedly influence the investment decisions that Special Entities make. Clearly, in those circumstances, Special Entities should have the benefit of the additional protections in the statute, as Congress intended and as the text of the Dodd-Frank Act provided.

As suggested in the Release, a more appropriate definition would be one that parallels the definition of an ***investment advisor***. Such a definition would encompass "advising Special Entities as to the value of security-based swaps or as to the advisability of security-based swaps or trading strategies involving security-based swaps."[29] The definition in the Proposed Rules should be expanded accordingly.

The Exemption from the Definition of "Advisor," Applicable When Independent Representatives Are Involved, Should Be Eliminated.

The Proposed Rules include an exemption that would allow an SBS Entity to act as an advisor to a Special Entity without being held to the heightened standards set forth in the Dodd-Frank Act. The exemption would apply where the Special Entity represents in writing that it will not rely on the recommendations provided by the SBS Entity and that it will instead rely on advice from a qualified independent representative.[30] This exemption is not consistent with the language, structure, or purposes of the Dodd-Frank Act and it should be deleted from the Proposed Rules.

The provisions in the Dodd-Frank Act governing the duties of SBS Entities that act as advisors to Special Entities contain no exceptions. The statute unequivocally states that SBS Entities acting as advisors to Special Entities "***shall comply*** with the requirements of paragraph (4) with respect to such entity."[31] Paragraph (4) in turn, which contains the best

[29] Release at 42425. Note that the definition of "advisor" in the context of SBS Entities should differ from the investment advisor definition in at least one important respect. The investment advisor definition incorporates the concept of compensation. This should not be included in the Proposed Rules, since a Special Entity should receive the additional protections whether or not the advice it receives from an SBS Entity is compensated. One reason for the distinction is the opportunity that SBS Entities have to derive compensation for their advice indirectly, by entering into SBS transactions with Special Entities as counterparties.

[30] Release at 42424.

[31] Exchange Act § 15F(h)(2)(A), as added by Dodd-Frank Act § 764(a) (emphasis added).

interest standard and the anti-fraud provisions applicable to advisors, also includes no exceptions.[32] Obviously, Congress did not intend to create any exemptions that would allow SBS Entities to dispense advice to Special Entities without being subject to the heightened standard of conduct.

The case against the exemption in the Proposed Rules is especially strong in light of other provisions in the Dodd-Frank Act that condition certain activities of SBS Entities on the involvement of independent representatives. For example, immediately following the advisor provision is a paragraph allowing SBS Participants ***to enter into SBS transactions*** with Special Entities ***provided*** certain conditions are met.[33] Among those conditions is that the Special Entity counterparty have an independent representative who is knowledgeable and who will undertake to act in the best interests of the Special Entity.[34]

Clearly, Congress was mindful of the role that a qualified independent representative could play in safeguarding the interests of a Special Entity. Therefore, Congress could have readily incorporated an exemption for advisors that similarly relies upon the involvement of an independent representative. However, it chose not to do so, and the Proposed Rules must not overturn this Congressional determination.

Finally, there is no practical justification for the exemption. In effect, what the industry seeks to gain from the exemption in the Proposed Rules is the right to provide advice that may not actually be in the best interests of the Special Entity, without any accountability. The Proposed Rules must not create such a large loophole that is wholly inconsistent with the language and intent of the Dodd-Frank Act.[35]

The Definition of "Independent Representatives" Must Be Strengthened To Eliminate Conflicts of Interest.

In accordance with the Dodd-Frank Act, the Proposed Rules would impose conditions on the ability of SBS Entities to enter into SBS transactions with Special Entities. Specifically, they would require the SBS Entity to have a reasonable basis for believing that the Special Entity had an independent representative who met certain tests.[36] Among other criteria, the independent representative must be sufficiently knowledgeable to evaluate the SBS transaction and its risk, and it must undertake a duty to act in the best interests of the Special Entity.[37]

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[32] Exchange Act § 15F(h)(4), as added by Dodd-Frank Act § 764(a).
[33] Exchange Act § 15F(h)(5), as added by Dodd-Frank Act § 764(a).
[34] *Id.*
[35] The exemption is unfounded on another level as well. If the conditions of the exemption are really met, then the independent representative is supplying whatever advice the Special Entity needs, and there is no reason for the SBS Entity to be acting as an advisor at all. Conversely, if the Special Entity still seeks advice from the SBS Entity, notwithstanding the input it receives from its independent representative, then the Special Entity will presumably rely on that advice to at least some degree and there would no conceivable justification for not subjecting the SBS Entity to the best interest standard. In short, the exemption is either totally unnecessary or totally unjustifiable.
[36] Release at 42425.
[37] *Id.*

Under this regime, the independent representative plays an enormously important role in protecting the Special Entity whenever it is entering into transactions with SBS Entities. Accordingly, it is vital that the independent representative be truly independent from the SBS Entity involved. However, the Proposed Rules do not accomplish this goal.

For example, the Proposed Rules would define "independent representative" to include persons who have earned as much as 10 percent of their gross revenues from the SBS Entity over the prior year.[38] In addition, the definition would include persons who were associated persons of the SBS Entity only a year prior to serving as independent representative for the Special Entity.[39]

Both of these criteria are far too weak. The Proposed Rules should disqualify representatives who have received any compensation of any kind, directly or indirectly, from the SBS entity over the prior year, and the bar on associated person status should be at least doubled to cover the two prior years. Additionally, representatives and associated persons must be barred from, directly or indirectly, working for or receiving compensation from any SBS Entities for a year ***after*** they act as an independent representative for any Special Entity.

Permitting obvious conflicts of interest to persist is not consistent with the law and it will not adequately protect the interests of Special Entities.

The Proposed Rules Must Adopt the Stronger Standard for Determining When an SBS Entity May No Longer Rely on Information Obtained from Independent Representatives and Others.

To satisfy the conditions in the Proposed Rules, an SBS Entity would have to determine that an independent representative satisfied the applicable criteria, including those relating to knowledge and independence. Much of that information will have to be derived from representations made by the independent representative or the Special Entity. The Release seeks comment on two possible approaches for determining when such representations are no longer reliable and may not be relied upon by an SBS Entity absent further inquiry.[40] This is an important and recurrent issue throughout the Release, and it arises in multiple situations where SBS Entities must gather information from other sources to discharge their duties under the Proposed Rules.

The first approach would permit an SBS Entity to rely on a representation from another person unless it ***knows*** that the representation is inaccurate.[41] The second approach would permit an SBS Entity to rely on a representation from another person unless the SBS Entity ***has information that would cause a reasonable person to question the accuracy*** of the representation.[42]

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[38] Release at 24246.
[39] *Id.*
[40] Release at 42426-27.
[41] Release at 42427.
[42] *Id.*

The second standard is stronger and it is the one that the Commission must adopt throughout the Proposed Rules as the test for determining whether an SBS Entity may rely on representations from other persons. It will help ensure that SBS Entities are acting on reliable information. For example, under the second test, if an SBS Entity received any information that would cause a reasonable person to question the accuracy of a representation from a counterparty, it would have a duty "to make further reasonable inquiry to verify the accuracy of the representation."[43]

In addition, the second test is objective rather than subjective, and it will therefore be easier to monitor and enforce. Applying this test in all instances when SBS Entities must gather information to meet their obligations under the Proposed Rules will help promote full compliance with all of the new standards governing SBS Entities.

The Proposed Rules Must Require Major SBS Participants, as Well as SBS Dealers, to Disclose the Capacity in Which They Are Acting When They Enter SBS Transactions with Special Entities.

The Dodd-Frank Act requires both types of SBS Entities to disclose the capacity in which they are acting when they enter into a transaction with a Special Entity.[44] The duties that SBS Entities owe to Special Entities vary significantly under the Dodd-Frank Act and the Proposed Rules. For example, as discussed above, advisors to Special Entities are subject to a best interest standard. It is therefore important for Special Entities to understand the capacity in which an SBS Entity is acting before engaging in an SBS transaction with such an Entity.

However, the Proposed Rules would apply this disclosure obligation only to SBS Dealers, not Major SBS Participants. This position is based on the same type of statutory ambiguity that appears in other parts of Section 764 of the Dodd-Frank Act—the general duty of compliance refers to both types of SBS Entities, but the specific provision at issue could be narrowly read as referring to only one.

As in those other instances, discussed above, the Proposed Rules should resolve the issue in favor of the approach that maximizes protections for Special Entities. In this case, that means requiring Major SBS Participants, as well as SBS Dealers, to disclose the capacity in which they are acting when they enter SBS transactions with Special Entities.

The Proposed Rules Must Narrow the Exemption from Compliance with the Special Entity Provisions in Accordance with the Statutory Language.

The Dodd-Frank Act provides that the new protections afforded to Special Entities shall not apply if two conditions are met: (1) the transaction is initiated by the Special Entity on an exchange or SBS execution facility ("SBS SEF"); and (2) the SBS Entity does not know the identity of the counterparty to the transaction.[45]

[43] *Id.*
[44] Exchange Act § 15F(h)(5)(A)(ii), as added by Dodd-Frank Act § 764(a).
[45] Exchange Act § 15F(h)(7), as added by Dodd-Frank Act § 764(a).

The Proposed Rules implement this exemption by ignoring the first condition altogether and applying only the second condition.[46] Thus, provided that the SBS Entity does not know the identity of its counterparty, and the transaction is executed on an SBS SEF or exchange, then the special protections afforded to Special Entities would not apply regardless of whether or not the Special Entity initiated the transaction.

This approach impermissibly ignores one of the elements of the exemption mandated by the statute. By denying the exemption in situations where the ***SBS Entity*** initiates a transaction, the statute intends to ensure that if SBS Entities seek out business from parties that *may* be Special Entities, then the SBS Entities must bear the risk that their counterparties are Special Entities entitled to added protections. The statute thus incentivizes an SBS Entity to ascertain the identity of its counterparty when it initiates SBS transactions. The Proposed Rules would eliminate this element of the exemption.

The rationale for the Commission's approach is unconvincing. The Release explains that "there may be circumstances in which it may be unclear which party, in fact, 'initiated' the communications that resulted in the parties entering into a security-based swap transaction."[47] This ignores the fact that Special Entities are special for a reason and are entitled to the statutory protections. Potential, occasional lack of clarity is not a valid basis for cutting back or gutting the conditions for the exemption. SBS Entities must bear the risk of ambiguity if, on occasion, it is unclear which entity initiated the transaction.

It is incumbent upon the Commission to formulate an appropriate and clear test for determining when a Special Entity initiates an SBS transaction. To serve the protective purposes of the statute, the definition must be narrowly framed and it must not encompass activities that represent initiation of negotiations as opposed to initiation of a transaction. The possible definition suggested in the Release is too broad for just this reason. The Release asks whether the exemption might be "limited to situations in which the Special Entity takes specific steps, such as submitting a request for quote or some other communication regarding a potential transaction on an exchange or SEF."[48]

This test is not adequate since a mere request for a quote is actually the commencement of a negotiating process, even if it is conducted over a SEF. This could certainly result in the type of negotiation between an SBS Entity and a Special Entity in which the added protections for Special Entities under the Dodd-Frank Act clearly should apply. Instead, the communication by the Special Entity must be limited to an initiating communication in which the response would constitute a matched transaction without need for further action. The SBS Entity would hit or lift the transaction, not negotiate terms. Above all, the Commission must not, and need not, ignore the statutory requirements for the exemption.

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[46] Release at 42421.
[47] *Id.*
[48] *Id.*

The Provisions in the Proposed Rules Dealing with Chief Compliance Officers Should Be Enhanced with Additional Measures Designed to Ensure the Effectiveness and Independence of the CCO.

The Proposed Rules implement the provisions in the Dodd-Frank Act relating to the appointment and duties of the CCO of an SBS Entity. Although they are generally appropriate as far as they go, the Proposed Rules should incorporate additional measures that will help ensure the effectiveness and independence of the CCO.[49]

The Proposed Rules Should Impose Qualification Standards on CCOs.

The Proposed Rules should require the CCO to meet competency standards to ensure that the person has the background and skills appropriate for fulfilling the responsibilities of the position. These standards should include a lack of disciplinary history in addition to criteria demonstrating relevant knowledge and experience. Furthermore, the CCO must not be the general counsel or a member of the legal department of the SBS Entity.

The Proposed Rules Should Provide for CCO Oversight Solely by Independent Board Members.

In light of the pressures that are brought to bear on CCOs, the Proposed Rules must include a number of provisions to help ensure the independence of the CCO. Greater reliance on oversight by independent members of the boards of directors is an important component of these provisions. Those board members are independent from senior management and are more likely to view compliance as a worthy goal rather than an obstacle.

Decisions relating to the designation of the CCO, the CCO's compensation, material changes in the CCO's responsibilities, and termination of the CCO should be the sole responsibility of the independent members of the board acting by majority vote. In addition, the CCO should have a direct line of reporting to the independent directors or the audit committee.

The Proposed Rules Should Prohibit Coercion or Other Interference with the CCO.

The Proposed Rules should include a provision explicitly prohibiting any officers, directors, or employees of an SBS Entity from directly or indirectly taking any action to coerce, manipulate, mislead, or fraudulently influence the CCO in the performance of his responsibilities.

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[49] In other comment letters, we have previously urged the Commission to adopt such additional measures relating to CCOs. *See* Comment Letters from Better Markets, Inc., to the Commission dated Jan. 24, 2011 (on regulation of SBS swap data repositories, File No. S7-53-10); Apr. 4, 2011 (on regulation of SBS swap execution facilities, File No. S7-06-11); and Apr. 29, 2011 (on clearing house regulation, File No. S7-08-11).

The Proposed Rules Should Require the Board to Review the CCO's Annual Report and Either Formally Approve It or Provide Comment.

The Proposed Rules would require the CCO to prepare a certified annual report describing the clearing agency's policies and procedures relating to compliance matters and further describing its compliance with applicable laws and regulations. The report must be submitted to the board, the audit committee, and the senior officer of the SBS Entity before being filed with the Commission.[50]

These important provisions should be enhanced to require the board and the audit committee to review the CCO's report and either approve it or prepare a written statement of any disagreements they may have. Furthermore, any approvals or objections should accompany the report when it is filed with Commission.

<u>CONCLUSION</u>

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

Dennis Kelleher by SWH

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Securities Specialist

Better Markets, Inc.
Suite 1080
1825 K Street, N.W.
Washington, D.C. 20005
(202) 618-6464

www.bettermarkets.com

dkelleher@bettermarkets.com
shall@bettermarkets.com

[50] Release at 24236-37.