Consumer Federation of America

AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY • FAIRNESS • SECURITY

February 22, 2011

David A. Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st St., N.W.
Washington, D.C. 20581

**Re: RIN number 3038—AD25**

Dear Secretary Stawick:

We are writing on behalf of the Consumer Federation of America (CFA)[1] and Americans for Financial Reform (AFR)[2] in strong support of the Commission's proposed external business conduct standards for swap dealers and major swap participants. While there are a number of areas where we believe the proposed rules should be strengthened, overall the Commission has done an excellent job of outlining a strong and comprehensive set of business conduct rules. If strengthened along the lines we have specified below and implemented effectively, these rules would significantly enhance the integrity of the over-the-counter swaps market and better ensure that this market benefits rather than exploits the many commercial end users, government entities, endowments, and pension funds that rely on swaps to hedge risks.

## 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

[1] The Consumer Federation of America (CFA) is an association of nearly 300 nonprofit consumer groups that was established in 1968 to advance 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.)

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 spring 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" 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. 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 spring 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

---

[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.

time around," and they refer to certain clients as "too smart to buy this junk."[6] One 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]

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 SEC's 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] 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, 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 brought the county to the brink of bankruptcy.

---

[6] Ibid.
[7] Ibid.
[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.

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 fee that it was ultimately required by the SEC settlement to relinquish.

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 county taxpayers will be paying off 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 Wall Street Reform and Consumer Protection Act (DFA) granting the CFTC broad authority to adopt business conduct rules for swaps dealers and major swaps

---

[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.
[14] Ibid.
[15] Yves Smith, "JP Morgan Under Criminal Investigation for Jefferson Country, Other Swaps," *Naked Capitalism* blog, Oct. 29, 200, available at: http://www.nakedcapitalism.com/2008/10/jp-morgan-under-criminal-investigation.html.

participants. And it is with these sorts of abuses in mind that the CFTC 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;
- 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 costs and risks, of any recommended 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 noted at the outset of this letter, while there are a number of areas where we would like to see the rules strengthened, we believe the CFTC has generally done an excellent job of drafting rules that fulfill these goals and match the scope and seriousness of the problems they are intended to address. Our comments on the rule proposal follow.

## II. The Rule Proposal

### *A. Business Conduct Rules – Dealing With Counterparties Generally*

Scope and Applicability: The Commission has done an excellent job of providing the general framework of the business conduct rules. We strongly support provisions of proposed §23.400 which define the scope of the rules as supplementing, rather than supplanting, other provisions of the Commodity Exchange Act (CEA); which apply to swaps that are offered as well as those that are entered into; and which extend those obligations to all persons acting on behalf of the swap dealer or major swap participant. 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. Moreover, by applying the rules to all those acting on behalf of the swap dealer or major swap participant, the Commission helps to ensure that these market participants will not be able to evade the rules by doing through third parties what they would not be permitted to do directly.

We support certain statements in the proposing release designed to clarify and, in some cases limit, the scope of the rule. Consistent with our view that the standards should be scalable depending on the degree of reliance, we concur with the view expressed that these rules should have 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." Further, we agree with the Commission proposal to largely exempt 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 to transactions where both parties to the deal are swap dealers or major swap participants. In an anonymous transaction there can, by definition, be no reliance by one party on the recommendations of the other. 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.

Know Your Counterparty: We support the provisions of §23.402 that require the swap dealer or major swap participant to adopt and implement policies and procedures reasonably designed to ensure compliance with the business conduct rules and to monitor and diligently supervise compliance with those policies and procedures. In particular, we believe the "know your counterparty" requirements are essential components of an effective business conduct rule regime. We would urge the Commission to strengthen the record-keeping requirements associated with the "know your counterparty" rule to clarify that records must be sufficient to enable regulators to determine the dealer or swap participant's compliance with their suitability or best interest obligations. As such, the records must provide documentation to support the conclusion reached by the swap dealer or major swap participant that a particular swap or trading strategy was either suitable or in the best interest of the counterparty, depending on the standard that applies.

Reliance on Representations: We generally support the approach the Commission has proposed to adopt allowing swap dealers and major swap participants to satisfy their obligations through reliance on written representations of a counterparty. By requiring that the swap dealer or major swap participant 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 and also requiring and that the representations are sufficiently detailed to allow such an assessment, the proposed rule should provide an adequate basis for regulators to enforce compliance without being unduly prescriptive in laying out the means of compliance. Again, however, we would urge the Commission to specifically require retention of records that are sufficiently detailed to allow regulators to easily determine compliance. This would have the further benefit of allowing the Commission to determine going forward whether there are common areas of poor or non-compliance where additional guidance is needed.

Fraud: In light of what Congress was responding to in adopting the business conduct provisions of the derivatives title, the anti-fraud rules in §23.410 are among the most important elements of the rule proposal. We strongly support the Commission proposal to adopt broad anti-fraud rules and to apply those rules to swap dealers and major swap participants acting in any capacity in relation to counterparties generally. While the legislation subheading refers to "Special Requirements for Swap Dealers Acting as Advisors," there can be no legitimate reason to allow fraudulent, manipulative, or abusive practices in any context. Moreover, the statutory language itself is quite broad, applying to "any device, scheme or artifice to defraud," "any transaction, practice, or course of deceit," and "any act, practice, or course of business that is fraudulent, deceptive or manipulative." There can be no doubt, in our view, that Congress intended to apply these principles to the broad range of conduct engaged in by swap dealers and major swap participants with regard to counterparties generally and special entities in particular.

The specific prohibitions proposed against disclosing confidential counterparty information or front running or trading ahead of counterparty information are both appropriate and consistent with congressional intent to provide protections to counterparties where their interests are in conflict with those of the swap dealer or major swap participant. As such, we would strongly oppose any effort to limit prohibitions on disclosing confidential counterparty information. On the other hand, we believe it may be reasonable and appropriate to provide a time limit with regard to the prohibition on front-running. If the Commission were to adopt such an approach, it might want either to require additional disclosures before the transaction could be entered into or require that the swap dealer or major swap participant have reasonable grounds for believing the counterparty does not intend to enter into the transaction in the near future before permitting the transaction.

We do not believe it is necessary to require a swap dealer or major swap participant in all instances to disclose its pre-existing positions in a type of swap prior to entering into the same type of swap with a counterparty. Rather, the guiding principle in determining whether such disclosures would be necessary would be whether the existence of those positions creates a material conflict of interest. If, for example, the swap dealer or major swap participant was taking a major short position in a type of swap in which it was recommending the counterparty take a long position, the swap dealer or major swap participant should be required to disclose that fact as part of its conflict of interest disclosures along with its reasons for believing the counter position is nonetheless appropriate for or in the best interests of the counterparty. Absent a material conflict of interest, however, we do not see the utility of requiring such disclosures. On the other hand, it may be appropriate for the Commission to require the swap dealer or major swap participant to maintain records with regard to its position in swaps of a type that it recommends to counterparties in order to better enable regulators to determine whether the swap dealer or major swap participant is fully complying with conflict of interest disclosures and suitability and best interest obligations.

As a general matter, we believe the broad prohibition on fraudulent, manipulative, deceptive, and abusive conduct should give the Commission the authority it needs to address problematic conduct that it identifies in the course of its supervisory activities. There are two areas, however, where we encourage the Commission to consider adopting additional specific prohibitions. The first involves situations in which a counterparty seeks to enter a swap in order to hedge a particular risk. It should be considered an abusive practice to recommend a swap or a trading strategy that, though it allows the counterparty to achieve the desired result, does so in a way or includes features that expose the counterparty to risks greater than those it seeks to hedge. The second involves recommending customized swaps where the counterparty could achieve the same result at a lower cost through the use of standardized swaps. In both these cases, it may be possible to achieve the desired result through appropriate application of the proposed suitability and best interest standards. Regardless of where in the rulebook it fits, we urge the Commission to make explicit its view that both these practices would be unacceptable under the business conduct rules.

The Commission may identify patterns of abusive conduct in the future where it would be appropriate to further elaborate on these broad anti-fraud principles by adopting specific prohibitions. As a general matter, however, we believe the Commission should avoid attempting to nail down with excessive specificity the conduct that would be deemed to violate the standard, since doing so could have the unintended consequence of limiting its scope. The risk of such an approach is that courts would come to view any conduct not specifically prohibited by rule as permitted under the standard. In general, a broad, enforceable principles-based approach is the best approach for promoting market integrity.

Verification of Counterparty Eligibility: The procedures included in §23.430 of the proposed rule for verifying the eligibility of counterparties to enter swap transactions and for determining whether the counterparty is a "special entity," while generally appropriate, would benefit from greater clarification. Specifically, the Commission should clarify that written representations relied on must be sufficiently detailed to allow the swap dealer or major swap participant to make the required determination. Moreover, where there is an on-going relationship or repeated transactions, it may be appropriate to require that those written representations be updated whenever there is a change that could impact the counterparty's eligibility or status. We also believe swap dealers and major swap participants might benefit from more extensive guidance on what would constitute a "red flag" that requires extensive review. Alternatively, the Commission could provide further guidance only if, in the course of its supervisory activities, it finds that there is a pattern of weak or non-compliance that requires further action. To aid the Commission in making that determination, and to assist in its oversight generally, the Commission should clarify that swap dealers and major swap participants are required to maintain records sufficient to enable regulators to determine that they have appropriately followed the required procedures.

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. In general, the Commission has done an excellent job in §23.431 of the proposed rules of crafting disclosure requirements that would both greatly assist counterparties in making informed decisions and help to deter abusive conduct. In particular, we commend the Commission for recognizing that standardized disclosures alone would not be adequate to elucidate the risks in customized swaps. However, there are areas with regard to risk and conflict disclosure in particular, where we believe the requirements should be strengthened.

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. We are particularly pleased that the Commission has proposed that disclosures be provided at "a reasonably sufficient time prior to entering into a swap" and "in a manner reasonably designed to allow the counterparty to assess" key features of the proposed transaction. We encourage the Commission to interpret this requirement to prevent last-minute, point-of-sale disclosures that provide the illusion but not the reality of informed choice. Ideally, these disclosures should be provided with, or at the earliest possible time following, the recommendation or offer to enter into a swap. Moreover, while we agree that it is reasonable to permit the counterparty and the swap dealer or major swap participant to agree on the appropriate format for the required disclosures, we would impose one important condition. Disclosures must be provided in a form that allows regulators to determine whether the information provided was both accurate and sufficient.

*Material Risks:* The proposed rule does an excellent job of describing the material risks that would have to be disclosed by swap dealers and major swap participants. In particular, we strongly support the proposal to require swap dealers and major swap participants recommending a high-risk swap to provide a scenario analysis, designed in consultations with the counterparty, to enable the counterparty to assess its potential exposure. We believe the proposed scenario analysis could provide extremely useful information that would better enable counterparties to assess risks associated with swaps transactions and trading strategies.

While we are generally strongly supportive of this proposed rule, we believe several strengthening amendments are needed. First, in order to minimize the potential for confusion, the swap dealer or major swap participant should be required, as part of the scenario analysis, to disclose the assumptions on which the scenario is based and the scenario's sensitivity to those assumptions.[16] Moreover, those assumptions should have to reflect a wide range of potential scenarios and be reasonably designed to fully reflect the maximum potential exposure of the counterparty. In addition, we have a serious concern about the proposal to make the scenario analysis optional for certain bilateral swaps. One concern is that the distinction between high-risk and other swaps is not sufficiently clear. This is not a failing of the Commission proposal, which provides reasonable factors to consider in making that distinction, but rather is an inherent characteristic of a complex and constantly changing market. We have, after all, just experienced a major financial crisis based at least in part on a failure of many sophisticated financial market participants to appreciate the risks associated with mortgage-backed securities. A better approach would simply be to require the scenario analysis in all instances involving swaps that are not available for trading on a DCM or SEF.

Because swap dealers and major swap participants expect to take the opposite side of the recommended transaction, we find it highly unlikely that they are not performing such scenario analyses for their own purposes. This should make it a relatively simple matter to adapt the analysis for the purposes of the counterparty. Second, we do not believe a swap dealer or major swap participant could satisfy its suitability or best interest obligation without first conducting such an analysis, so there should be minimal additional cost associated with sharing that information with the counterparty. We are encouraged that several large dealers have apparently informed the Commission they would be willing provide the scenario analysis at no charge to the counterparty. If the Commission does not accept our recommendation to require the scenario analysis for all bilateral swaps not available for trading on a DCM or SEF, it should at least

[16] This is similar to the requirement DFA imposed on credit rating agencies in disclosing their ratings.

require the scenario analysis for all special entities and for other less financially sophisticated counterparties.[17]

Requiring the scenario analysis for all bilateral swaps not available for trading on a DCM or SEF has an added benefit. Not all counterparties enter the swaps market with entirely pure motives. Some may seek to use opaque bilateral swaps in order to evade regulatory restrictions, such as restrictions on leverage, or engage in practices indirectly that they would be prohibited from engaging in directly. As derivatives expert Richard Bookstaber noted in testimony before the Senate Agriculture Committee,[18] "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."[19] Requiring a scenario analysis for the most opaque swaps – those bilateral swaps not available for trading on a DCM or SEF – could make it more difficult for counterparties to engage is these and similar questionable practices while arguing that they did not understand the risks.

In addition, 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:* A number of industry experts have suggested that many customized swaps are simply amalgamations of standardized swaps or combinations of standardized swaps and other non-swap component, such as a loan. Such practices make it possible 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

[17] Swap dealers and major swap participants would need to assess the counterparty's degree of sophistication in order to comply with the "know your counterparty" rules.
[18] Testimony of Richard Bookstaber before the Senate Committee on Agriculture, Nutrition and Forestry, "Regulatory Reform and the Derivatives Markets," June 4, 2009.
[19] Ibid.

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 seek to 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 JP 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 risk. Ideally, such practices would be eliminated, at least with regard to special entities. 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.

*Material Incentives and Conflicts of Interest:* The proposing release does a good job of laying out the details regarding compensation and third-party payments that would constitute a material incentive or conflict of interest requiring disclosure. In particular, we strongly support requiring the swap dealer or major swap participant, when recommending a swap, 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." The Commission should clarify, however, 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. 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."[20]

The Commission must seek to ensure that its required disclosures are 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 help be particularly helpful in this regard.

In this context, we do not believe the proposal to require disclosure of the mid-market value of the swap adequately satisfies the recommendation by some stakeholders, cited in the proposing release, to require disclosure of the 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

---

[20] Ibid.

things, these disclosures should require clear, separate pricing of any imbedded credit for forgone collateral.

We are disappointed that, in discussing required disclosures regarding conflicts of interest, the proposal entirely ignores 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. We urge the Commission to clarify that swap dealers and major swap participants must do more than provide boilerplate disclosures about the conflicts of interest inherent in a counterparty relationship. As just one example, the Commission 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.

*Fair Dealing:* We believe the principles-based approach outlined in the proposing release's discussion of §23.433 of the proposed rules with regard to the duty to communicate in a fair and balanced manner is appropriate. 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 an enforceable, principles-based standard, as outlined in the proposing release, is likely to serve better than prescriptive rules.

Institutional Suitability: We strongly support the proposal in §23.434 to impose a suitability obligation on swap dealers and major swap participants when they make a recommendation in connection with a swap or a swap trading strategy. The industry has traditionally argued against an institutional suitability standard on the grounds that institutional investors are capable of looking out for their own interests and have the resources to absorb any potential losses. 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. Certain features built into swaps may expose users to losses significantly greater than they can afford to absorb. Moreover, imposing a suitability obligation on swap recommendations is 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 suitability recommendations has the potential to greatly ameliorate this problem.

The proposed approach outlined by the Commission adopts a reasonable balance. By imposing the suitability obligation where the swap dealer or major swap participant makes a recommendation, the proposal limits that obligation to situations where there is likely to be a degree of reliance by the counterparty on the swap dealer or major swap participant. As such, the distinction the rule proposal makes between recommendations and non-customer-specific communications is generally appropriate, in our view.[21] And the exemption for transactions between swap dealers and major swap participants also makes sense, since these market professionals should have the expertise to evaluate any swaps and are unlikely to be relying on their counterparty for recommendations.

We are concerned, however, that the provisions allowing the swap dealer to rely on counterparty representations – while appropriately limited – could be used to subvert the intent of the standard. 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. 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 the transactions suitable, and a swap dealer could have reasonably claimed that it was appropriate to rely on those representations. We see no value in permitting swap dealers and major swap participants to recommend swaps they know to be unsuitable just because the customer is willing to enter the transaction. Moreover, customization by its very nature implies that the swap has been designed with the particular needs of the counterparty in mind. We therefore see no benefit to allowing swap dealers and major swap participants to recommend customized swaps without first determining that they are suitable for the customer. For these reasons, we urge the Commission to require a suitability analysis wherever the swap dealer or major swap participant is the initiator in recommending the transaction or, at the very least, wherever the swap dealer or major swap participant recommends a customized swap or a trading strategy that uses customized swap. This would still leave swap dealers and major swap participants free to enter transactions initiated by the counterparty without first having to conduct a suitability analysis.

The Commission should also clarify that the swap dealer or major swap participant is required to document the basis on which it determined that a particular swap or trading strategy was appropriate. Records should be sufficiently detailed to enable regulators to easily determine compliance.

<u>Execution Standards</u>: 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.

---

[21] See related comments below in the section responding to arguments put forward in the SIFMA/ISDA comment letter.

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.

*B. Requirements for Swap Dealers Acting as Advisers to Special Entities*

Prompted in part by revelations of the Senate Permanent Subcommittee hearings and in part by the plight of local government entities 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. In addition, these organizations – whether government entities, pension funds, or endowments – had individuals behind them who stood to suffer significant harm if the entity entered transactions that exposed them to unacceptable and inappropriate risks. The goal of the legislation in this area was to ensure that swap dealers would act in the best interest of these more vulnerable counterparties when providing advice and making recommendations. In drafting the legislation, members of Congress used the Investment Advisers Act duty as their model.

When combined with the provisions of the general business conduct rules, and in particular the enhanced disclosures regarding risk and conflicts, the rules in for special entities proposed by the Commission would go a long way toward achieving the improved counterparty protections intended by Congress.

Definition of Special Entity: The Commission asks a series of questions regarding the definition of special entity in the statute. Most of these questions raise technical issues we are not well equipped to answer. In deciding such issues, we would encourage the Commission to err on the side of inclusiveness, particularly if the entity in question has the characteristics Congress considered in establishing the special entity category – lack of financial expertise and exposure through the entity of vulnerable citizens, such as workers and taxpayers, to losses. Accordingly, we would encourage the Commission to include charitable organizations on the list of special entities. In addition, the Commission should avoid creating exemptions that would provide an easy means of evading the statute's requirements.

The one 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 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, committee staff engaged in extensive negotiations with representatives of government pensions in order to ensure that the legislation would be workable for them. Far from wishing to write them out, the taxpayers and government workers who stand behind government pensions are precisely the sort of constituents Congress sought to protect through the heightened duty.[22]

Acting as an Advisor: We strongly support the Commission's interpretation in §23.440 that making a recommendation constitutes acting as an adviser. The original Senate language imposed a fiduciary duty on all interactions between swap dealers and special entities. While we agree that this was ultimately an unworkable approach, it does provide an insight into congressional intent that the heightened standard of care be broadly applied. Applying the heightened duty to recommendations strikes a reasonable balance by limiting the duty to instances in which special entities would be relying on the swap dealer or major swap participant. Limiting the duty to situations in which the swap dealer or major swap participant acts in a more traditional advisory capacity – such as circumstances in which they have discretionary authority – would drastically reduce its reach, far beyond that intended by Congress. Moreover, defining recommendations as advice is consistent with the approach that SIFMA and other industry groups have taken in suggesting a definition for personalized investment advice in the context of the SEC's Section 913 study.[23] While it may be appropriate to offer some limited additional guidance on precisely what does and does not constitute making a recommendation, we believe this is a fairly straightforward concept that is well understood in the industry.

Best Interests: We support the Commission's proposed principles-based approach to the best interest standard, where the nature and extent of the duty would be determined by the facts and circumstances of the case. This is consistent with the approach to fiduciary duty under the Investment Advisers Act, which is the approach Congress sought to copy in imposing this duty. Moreover, it allows for a flexible standard that can be scaled up or down based on the sophistication and other financial circumstances of the special entity. The Commission is unquestionably correct in interpreting that this best interest standard is not intended to preclude swap dealers from entering into swap transactions with special entities that they also serve in an advisory capacity. This was the subject of extensive discussion as the legislative language was being finalized and is reflected in the Senate record, as reported in the proposing release. The goal was to ensure that conflicts would be fully disclosed and appropriately managed, and that the swap dealer would have a reasonable basis for believing its recommendation is in the special entity's best interests. In interpreting and implementing the standard, however, it is important to do so in a way that makes clear that best interest is a higher standard than suitability and involves a duty to ensure that the recommendation is not simply generally appropriate but is actually, in the view of the swap dealer, the best option for the special entity.

In addition, as we have discussed above, we believe there are certain practices which should be identified as inherent violations of the best interest standard. These should include designing swaps with features that expose the special entity to risks that are greater than those they intend to hedge and recommending customized swaps when the special entity could attain

[22] This issue is discussed in greater detail in the comment letter submitted by the American Federation of State, County and Municipal Employees (February 22, 2011 letter to CFTC from Gerald W. McEntee). We concur in the conclusions regarding the special entity definition contained in that letter.
[23] See further discussion of this point in the section below responding to issues raised in the SIFMA/ISDA letter.

the same results at a lower risk-adjusted cost using standardized swaps or an alternative strategy based on standardized components. Moreover, it is particularly important in the context of their dealings with special entities that the swap dealer provide conflict of interest disclosures that go beyond the issue of compensation and third-party payments and consider the full range of conflicts that may exist that are relevant to a particular recommendation. If the transaction is designed so that the swap dealer will profit if the transaction fails for the client, that too should have to be disclosed. Finally, as we have discussed above, we urge the Commission to require swap dealers, when recommending customized swaps, to break out the pricing of the various components of the swap, including the profit that it expects to make on the transaction and the cost of any imbedded credit for forgone collateral. Such an approach would be consistent with the Advisers Act requirement that the adviser disclose all material information, including information with regard to costs and conflicts of interest.

<u>Reasonable Efforts/Reasonable Reliance</u>: We support the Commission's interpretation of the "reasonable efforts" standard regarding the process a swap dealer must follow in determining whether a recommendation is in the best interests of a special entity. In particular, we agree that the additional categories of information the swap dealer would be required to analyze identified by the Commission would provide useful information in reaching that determination. We are confused, however, as to how the proposal to allow the swap dealer to rely on representations of the special entity to satisfy this obligation would work. The proposing release is not at all clear on this point, except to suggest that its intent is to create a mechanism to allow special entities to seek recommendations without providing adequate information to the swap dealer to enable them to determine best interest. While we agree that there should be a mechanism that enables special entities to discuss various options with swap dealers without divulging information they prefer to keep confidential, we are concerned that an overly broad interpretation of this the proposal may undercut the protections Congress intended to afford the taxpayers and workers and others who stand behind these special entities.

As we noted above, not all entities turn to the over-the-counter swap market for the purest of motives. And, if you survey the current economic scene to identify where the next trouble spot is likely to emerge, government pension funds would be a top prospect. Many if not most are under-funded, and many seriously so. And many continue to assume unreasonably high investment returns in an effort to help hide the extent of their underfunding. Unwilling or unable to seek additional taxpayer funding and reluctant to raise worker contributions, they have an enormous incentive to try to find ways to evade the restrictions in their investment charters in order to provide the higher returns built into their funding assumptions.

The Commission should take care that its proposal does not provide a means for entities in circumstances such as these to use the opacity and complexity of the customized swap market to pursue strategies that put workers and taxpayers at risk. In theory at least, the proposal that the swap dealer retain its best interest obligation in such circumstances should help to ensure that they obtain at least a minimum amount of information necessary to make an informed recommendation and that they err on the side of conservatism in their recommendations absent more complete information. We would encourage the Commission to clarify, however, that this is their intent and to consider whether it would be appropriate to specify certain information without which the swap dealer could not make a recommendation. Also, the Commission should clarify that the proposed disclosures about the limitations on their recommendations should be made to the board of the special entity and not simply to the investment officer.

Because special entities would retain their ability to engage in transactions with swap dealers and major swap participants as counterparties, the Commission need not fear restricting their access to the market if they tighten restrictions that apply to advisory relationships. Indeed, the Commission risks erasing this distinction between acting as an adviser and acting as a counterparty if, through its reasonable reliance proposal, it allows recommendations to be made on insufficient information. We therefore urge the Commission to consider whether there are other steps it might take to further restrict the potential for abuse under the "reasonable reliance" proposal.

C. *Requirements for Swap Dealers and Major Swap Participants Acting as Counterparties to Special Entities*

The statute seeks to ensure that all special entities have a representative with the expertise and independence necessary to evaluate swap transactions on their behalf. Toward this end, it 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. In §23.450 the Commission has generally created a reasonable and workable approach that is consistent with congressional intent.

<u>Independent Representative</u>: We concur 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 to serve this function. Moreover, we believe the proposed standard generally provides the appropriate level of independence. One exception is the proposal to allow the swap dealer to compensate the independent representative at the written direction of the special entity. This 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 Commission has provided an exception that would permit the receipt of some compensation by the representative from the swap dealer, so long as that compensation does not constitute a business relationship and is disclosed to the special entity. We encourage the Commission to clarify that disclosure of compensation to the representative be made to the board of the special entity, and that the written agreement that such payment does not constitute a material business relationship come from the board.

<u>Disclosures</u>: We strongly support the Commission's definition of "appropriate disclosures" as "appropriate and timely disclosures." As we have noted above, timeliness is one of the three key characteristics of effective disclosures (along with content and accessibility), and one that is often overlooked.

<u>Reasonable Representations</u>: The Commission proposes, appropriately in our view, to allow the swap dealer or major swap participant to rely on special entity representations regarding practices the independent representative follows in evaluating fair pricing and

appropriateness of swaps. Putting too much authority in the hands of the swap dealer or major swap participant in this regard 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.

Unqualified Independent Representative: We support the procedures the Commission proposes to put in place when a swap dealer or major swap participant determines that an independent representative is unqualified. Making the Chief Compliance Officer responsible for reviewing the determination should help to limit potential abuses. We encourage the Commission to further require that the Commission itself be notified in such cases and be provided with a copy of the written record explaining the basis of the determination.

### *D. Political Contributions by Certain Swap Dealers and Major Swap Participants*

We strongly support the Commission proposal in §23.451 to "prohibit swap dealers and major swap participants from entering into swaps with 'municipal entities' if they make certain political contributions to officials of such entities." 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. We urge the Commission to strengthen the rules in one area. While they prohibit swap dealers from entering into a swap within two years after making a political contribution, the rules do not appear to restrict the swap dealer from making a political contribution after the completion of a transaction. While this may be covered by the provision preventing evasion of the rules, we urge the Commission to clarify that the restriction on political contributions is forward-looking as well as backward-looking.

## III. Response to Certain Points Raised in the SIFMA/ISDA Comment Letter

As we were completing our comment letter, SIFMA and ISDA released the comment letter they have submitted opposing many aspects of the proposed rules. While there are a few technical issues raised by the groups that could be used to refine the proposed rules, many of the points they make are patently absurd and ignore congressional intent to broadly transform this market. This section of our letter is not intended to respond to every argument raised in the SIFMA/ISDA letter, which would require us to at least double the length of our comment letter. Rather, our goal is to point out some of the most egregious arguments put forward in the letter and to urge the Commission not to be swayed by these false arguments.

Of the many questionable assertions contained in the SIFMA/ISDA letter, perhaps the most absurd is the repeated suggestion that Congress, in providing the Commission with broad discretionary authority to adopt business conduct rules, intended that the Commission limit its rules to those mandated under the legislation. Similarly baseless is the suggestion that the Commission must not impose duties as Commission rules that involve "subjective judgment, rather than a clear objective standard." This is a particularly cynical argument given the industry's long-time and ardent advocacy of principles-based regulation, which by its nature trusts industry to make subjective judgments about the best way to comply with those principles but, where effectively enforced, holds them accountable for doing so.

Another patently untrue statement on which much of the groups' opposition to the rule is based is that, "Congress intended parties to a swap to clarify the nature of their relationship, and not to transform the nature of their relationship." What the groups fail to recognize or acknowledge is the degree to which members of Congress were shocked by what they had learned through congressional hearings and media accounts about common industry practices. Moreover, with the adoption of the business conduct provisions of the act, Congress clearly intended not just to provide greater transparency, though that is important, but also to transform the nature of the relationships, particularly with regard to special entities. That their interest was not limited to enhancing protections for special entities, however, can be seen from the legislation itself, as well as from the record of the Permanent Subcommittee on Investigations hearing, which involved issues much broader in scope than those relating to special entities and provided much of the impetus behind adoption of these business conduct provisions.

In their letter, SIFMA and ISDA repeatedly object to the notion that the Commission would adopt industry "best practices" as enforceable rules. Given the clear intent of Congress to raise the standard of conduct that exists in this market, looking to industry best practices seems like a highly reasonable approach. After all, such industry guidelines have by definition been endorsed by industry members as providing a workable and achievable approach to addressing particular issues. Indeed, our only concern is that, in a market where the standard of conduct has been so shockingly low, "best practices" may not set a sufficiently high bar for Commission rules.

In discussing proposed disclosures, the letter draws a false distinction between "information about" and "information . . . reasonably designed to allow a counterparty to assess." Requiring swap dealers and major swap participants to provide information *about* material characteristics or risks of swaps, without requiring that the information be sufficient to allow the counterparty to assess those characteristics or risks, would serve no useful purpose. The Commission has set a reasonable standard designed to ensure the counterparties receive the information they need to make an informed decision regarding whether to enter the transaction.

In contrast, two issues raised in the SIFMA/ISDA letter do in our view deserve serious attention:

> While we strongly support the "know your counterparty" rules proposed by the Commission, we agree that it may be appropriate to scale these rules according to the nature of the relationship between the counterparties. Where a truly arm's length relationship exists, for example, it may be appropriate to limit the "know your counterparty" obligation to information necessary to comply with the law. Where recommendations are made, however, the broader obligations outlined in the rule proposal would appropriately apply.
>
> The letter also raises a potentially legitimate issue with regard to what constitutes a recommendation. We are inclined to agree with SIFMA and ISDA that simply providing information tailored for the customer would not necessarily constitute advice if it were not paired with an actual recommendation. Carefully refining this definition of recommendation to allow for greater exchange of information could be beneficial for counterparties and make the rules more workable. In its letter to the SEC commenting on that agency's Section 913 study regarding fiduciary duty, SIFMA proposes a definition for personalized investment advice about securities that provides a useful guide. It

proposes 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 swap or a 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."

Overall, however, the changes to the proposed rules suggested by SIFMA and ISDA would have the effect of perpetuating the very abusive practices Congress sought to end with its adoption of legislation giving the CFTC sweeping authority to set business conduct rules. We urge you to ignore their efforts to maintain the status quo and to proceed instead with adoption of a strong set of business conduct rules as envisioned by Congress.

## IV. Summary of Proposed Strengthening Amendments

As noted above, we believe the Commission has done a good job of crafting a comprehensive set of business conduct rules. We have, however, suggested a number of amendments to strengthen those rules. The following is a summary of the strengthening amendments we have recommended:

- Strengthen record-keeping requirements throughout to ensure that records are detailed enough to allow regulators to easily determine compliance.

- Strengthen or clarify protections against recommending swaps that expose the hedger to risks that are greater than those they seek to hedge, either by identifying this as a violation of fraud standards or clarifying that it would be a violation of suitability and best interest standards.

- Clarify that recommending a customized swap where the counterparty could achieve the same result at a lower risk-adjusted price using standardized swaps would violate the suitability and best interest standards.

- Strengthen requirements regarding scenario analysis, by making them mandatory for all bilateral swaps that are not available for trading through a DCM or SEF and by requiring clear disclosure of the assumptions underlying the analysis and its sensitivity to those assumptions.

- Explicitly require swap dealers and major swap participants that recommend customized swaps to disclose alternative approaches using listed swaps and provide an assessment of the relative risks and costs of the two approaches.

- Where dealers recommend customized swaps that combine standardized components, the required disclosure of material characteristics should detail, and separately price, the standardized component parts of any customized swap, including any imbedded credit for forgone collateral.

- Strengthen conflict of interest disclosure requirements by clarifying 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.

- Strengthen the institutional suitability standard by limiting reliance on representations, requiring a suitability analysis wherever the swap dealer or major swap participant is the initiator in recommending the transaction or, at the very least, wherever the swap dealer or major swap participant recommends a customized swap or a trading strategy that uses customized swap.

- Create a narrower mechanism to allow for the exchange of information between counterparties, short of a recommendation, that does not permit broad reliance on counterparty representations that the transaction is suitable or special entity representations that the transaction is in their best interests. Do not allow recommendations to be made absent sufficient information to determine suitability or best interests.

- Do not allow independent representatives to special entities to be compensated by the swap dealer.

- When a swap dealer or major swap participant determines that an independent representative of a special entity is unqualified, require that the written report describing the basis for this determination be submitted to the Commission.

- Clarify that the restriction on political contributions is forward-looking as well as backward-looking.

## V. Conclusion

In crafting the business conduct provisions of the legislation and in granting the Commission broad authority to adopt business conduct rules, Congress sought to transform practices that had shocked the public when brought to light by congressional hearings and media accounts and provide sweeping new protections for the most vulnerable participants in this market. To achieve that goal, the Commission has proposed a generally sound set of external business conduct rules where the responsibilities of the swap dealer and major swap participant are appropriately determined by the nature of the transaction and the nature of relationship between the two parties to the transaction. Specifically, the Commission has appropriately sought to adopt rules that allow for and apply to a range of relationships and that impose the greatest protections where the reliance is greatest and the counterparties are least able to look out for their own interests. We particularly congratulate the Commission for recognizing the benefits that would flow from applying a broad institutional suitability obligation to recommendations of swaps and swap trading strategies and from applying execution standards to trades where the swap is available for trading on a DCM or SEF. If the strengthening amendments we have outlined above are adopted and the rules are implemented effectively, these rules should go a long way toward addressing the pervasive abuses that have existed for far too long in this market.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Lisa Donner
Executive Director
Americans for Financial Reform

Michael Greenberger, J.D.
Law School Professor
Founder & Director
University of Maryland
Center for Health and Homeland Security

Damon Silvers
Director of Policy and Special Counsel
AFL-CIO

cc: The Honorable Mary Schapiro, SEC Chairman
The Honorable Luis Aguilar, SEC Commissioner
The Honorable Kathy Casey, SEC Commissioner
The Honorable Troy Paredes, SEC Commissioner
The Honorable Elisse Walter, SEC Commissioner

## 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
- ACORN
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans for Fairness in Lending
- Americans United for Change
- Calvert Asset Management Company, Inc.
- 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 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
- 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
- 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