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May 27, 2014

Mr. Kevin M. O'Neill
Deputy Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Proposed Standards for Covered Clearing Agencies, File No. S7-03-14

Dear Mr. O'Neill:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposal of the Securities and Exchange Commission ("SEC") regarding the standards for covered clearing agencies (the "Proposed Rules"). Consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Proposed Rules establish additional requirements for risk management, operations, and governance of SEC registered clearing agencies that meet the definition of "covered clearing agency."

Under the Proposed Rules, covered clearing agencies would include clearing agencies designated by the Financial Stability Oversight Council ("FSOC") as systemically important for which the SEC is the supervisory agency; clearing agencies that act as central counterparties for security-based swaps; and clearing agencies that are determined by the SEC to be engaged in activities with a more complex risk profile.

## INTRODUCTION

As central counterparties to financial transactions, clearing agencies have long played a key role in mitigating risk and ensuring financial stability. The financial crisis of 2008 starkly revealed the need to expand the role of clearing agencies in the swaps markets, and to more generally strengthen the regulation and oversight of these crucial market participants.

Accordingly, Title VII of the Dodd-Frank Act requires most security-based swaps ("SBS") to be cleared; requires SBS clearing agencies to register with the SEC; and requires the SEC to adopt new regulations governing those SBS clearing agencies. In October of 2012, the SEC adopted new regulations to strengthen the substantive regulation of all registered clearing agencies, including those that clear SBS.

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

As a further indication of the importance of clearing agencies to the stability of our financial system, Title VIII of the Dodd-Frank Act requires enhanced oversight of clearing agencies that are designated as systemically important by the FSOC. On July 18, 2012, the FSOC designated six clearing agencies as systemically important, including The Depository Trust Company ("DTC"), Fixed Income Clearing Corporation ("FICC"), National Securities Clearing Corporation ("NSCC"), and The Options Clearing Corporation ("OCC"), which are subject to the supervisory authority of the SEC. The Proposed Rules have been issued in accordance with this requirement in Title VIII.

Title VIII also requires the SEC to consider international standards when promulgating rules relating to covered clearing agencies. Therefore, as the SEC formulated the Proposed Rules, it was guided by the international report on Principles for Financial Market Infrastructures issued by the Committee on Payment and Settlement Systems and the Technical Committee on the International Organization of Securities Commissions ("PFMI Report").[2] The PFMI Report has also heavily influenced the formulation of clearing agency rules finalized by the Commodity Futures Trading Commission ("CFTC") as well as proposed by the Federal Reserve Board. Generally, the PFMI Report sets forth principles that should be applicable to clearing agencies along with a list of key considerations that further explain each principle.

The Proposed Rules establish important enhancements in the oversight of covered clearing agencies, and they will help promote financial stability and contain systemic risk. However, as detailed below, there are several crucial respects in which the Proposed Rules must be strengthened if they are to fulfill the letter and spirit of the Dodd-Frank Act.

## OVERVIEW OF THE PROPOSED RULES

The Proposed Rules establish additional requirements for SEC-registered clearing agencies that are systemically important, that clear SBS, or that have a more complex risk profile (collectively "covered clearing agencies"). Specifically, in recognition of "the risks that their size, operation, and importance pose to the U.S. securities markets, the risks inherent in the products they clear, and the goals of Title VII and the Exchange Act,"[3] the Proposed Rules set forth certain enhanced requirements related to:

1. Legal Risk,
2. Governance,
3. Framework for the Comprehensive Management of Risks,
4. Credit Risk,
5. Collateral,
6. Margin,
7. Liquidity Risk,

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[2] *Available at* http://www.bis.org/publ/cpss101a.pdf.

[3] 78 Fed. Reg. 16,872.

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8. Settlement Finality,
9. Money Settlements,
10. Physical Delivery Risks,
11. Central Securities Depository,
12. Exchange-of-Value Settlement Systems,
13. Participant-Default Rules and Procedures,
14. Segregation and Portability,
15. General Business Risk,
16. Custody and Investment Risks,
17. Operational Risk Management,
18. Access and Participation Requirements,
19. Tiered Participation Agreements,
20. Links,
21. Efficiency and Effectiveness,
22. Communication Procedures and Standards, and
23. Disclosure of Rules, Key Procedures, and Market Data

These requirements track the principles for financial market infrastructures agreed to by international regulators in the PFMI Report.

## SUMMARY OF COMMENTS

The SEC should take a more prescriptive approach in finalizing the Proposed Rules that also incorporates the key considerations of the PFMI Report. But, merely adopting the key considerations is insufficient. Rather, the SEC must go further and strengthen the Proposed Rules to require covered clearing agencies to have robust standards and procedures that ensure accountability, independence, and financial stability.

While the SEC must reassess **all** of the Proposed Rules, adopt the key considerations of the PFMI Report, and take a more prescriptive regulatory approach, the SEC must pay particular attention to the Proposed Rules on Governance, Risk Management, Credit Risk, and Margin. Specifically, the SEC must ensure that:

- Conflicts of interest are appropriately managed, independent directors are sufficiently independent, the roles and responsibilities of the board of directors and management are clearly documented, and governance arrangements specify clear and direct lines of responsibility;

- The risk management framework of covered clearing agencies assigns responsibilities and accountability, is sufficiently independent, and includes a Chief Risk Officer; and

- The validation of credit risk and margin models is performed by an independent third party.

Finally, the SEC fulfilled its limited duty under the applicable provisions of the securities laws to consider whether the Proposed Rules promote efficiency, competition, and capital formation. However, the SEC can and should do more in the final rule release to clarify the nature of its obligation to conduct economic analysis, to limit the consideration of costs and benefits, and to appropriately emphasize the overarching goal of the securities laws to protect investors—the SEC's primary and overriding mission.

## COMMENTS

### I. The SEC should take a more prescriptive approach that also incorporates the key considerations of the PFMI Report.

Covered clearing agencies play a crucial role as a firewall against risks that could otherwise once again cripple the worldwide financial systems. However, as recognized in the PFMI Report, they "also concentrate risk."[4] And, "[i]f not properly managed, [covered clearing agencies] can be sources of financial shocks, such as liquidity dislocations and credit losses, or a major channel through which these shocks are transmitted across domestic and international financial markets."[5]

Thus, the need to ensure that they are appropriately regulated to manage this systemic risk is paramount. To do so, the SEC must ensure that **all** of the Proposed Rules are **more** prescriptive so that covered clearing agencies, their members, their members' customers, and the public are adequately safeguarded. Specifically, the SEC should **at a minimum** adopt the key considerations of each principle as identified in the PFMI Report.

Comprehensively adopting each of the key considerations will provide multiple benefits:

- Establishing stronger standards that more effectively address the risks the Proposed Rules are intended to address;
- Promoting fairness and consistency by ensuring that all covered clearing agencies are held to the same baseline level of safety and efficiency;
- Enhancing enforcement tools; and
- Promoting regulatory harmony by more fully embracing the PFMI standards, as the CFTC has already done and as the Board intends to do.[6]

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4 PFMI Report at 5.
5 *Id.*
6 79 Fed. Reg. 2,841 (the Board has indicated in its proposal that it "anticipates that it will be guided by the key considerations and explanatory notes of the PFMI [Report].")

But, merely adopting the key considerations is insufficient. Rather, the SEC must go further and strengthen the Proposed Rules to affirmatively require covered clearing agencies to have robust standards and procedures that ensure accountability, independence, and financial stability. Better Markets has consistently advocated for more prescriptive regulations governing clearing agencies. [7]

## II. A more prescriptive approach is warranted specifically for the Proposed Rules on Governance, Risk Management, Credit Risk, and Margin.

While the SEC must reassess **all** of the Proposed Rules, adopt the key considerations of the PFMI Report, and take a more prescriptive regulatory approach, there are four standards which warrant particular attention. Specifically, the Proposed Rules on Governance, Risk Management, Credit Risk, and Margin must be reevaluated and changed as follows.

### A. Governance: The SEC must ensure that conflicts of interest are appropriately managed, that independent directors are sufficiently independent, that the roles and responsibilities of the board of directors and management are clearly documented, and that governance arrangements specify clear and direct lines of responsibility.

Governance arrangements, which set forth the framework for the board of directors and management, are uniquely important at clearing agencies. Clearing members are both customers to the clearing agency and sources of collateral and liquidity for margin accounts and the guaranty fund. As a result, members "could use their influence to lower the risk management controls of a [clearing agency]" to reduce their own individual capital expenditures.[8] It is the duty of the board and management to resist this pressure and

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7 *See* Better Markets comment letters "Financial Resources Requirements or Derivatives Clearing Organizations" (Dec. 13, 2010), "General Regulations and Derivatives Clearing Organizations" (Feb. 11, 2011), "Information Management Requirements for Derivatives Clearing Organizations" (Feb. 14, 2011), "Risk Management Requirements for Derivatives Clearing Organizations" (Mar. 21, 2011), "Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges With Respect to Securities-Based Swaps Under Regulation MC" (Nov. 26, 2010), "Requirements for Derivatives Clearing Organizations, Designated Contract Markets. And Swap Execution Facilities Regarding Mitigation of Conflicts of Interest" (Aug. 26, 2011), "Enhancing Protections Afforded Customers and Customer Funds Held by Futures Commission Merchants and Derivatives Clearing Organizations" (Feb. 15, 2013), "Clearing Agency Standards for Operation and Governance" (Apr. 29. 2011), "Process for Submissions for Review of Security-Based Swaps for Mandatory" (Feb. 14, 2011), "Governance Requirements for Derivatives Clearing Organizations, Designated Contract Markets and Swap Execution Facilities; Additional Requirements Regarding the Mitigation of Conflicts of Interest" (Mar. 7, 2011), "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest" (Nov. 17, 2010), "Clearing Member Risk Management" (Sept. 30, 2011), "Customer Clearing Documentation and Timing of Acceptance for Clearing" (Sept. 30, 2011), "Effective Date for Swap Regulation" (Jul. 1, 2011),

8 Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges With Respect to Security-Based Swaps Under Regulation MC, 75 Fed. Reg. 65,885 (Oct. 26, 2010) (proposed rule).

prioritize the safety and stability of the clearing agency. But, this conflict of interest, among others, is not easily mitigated since clearing agency boards largely consist of the clearing members themselves.[9]

The Proposed Rules address this problem somewhat by requiring a covered clearing agency to "establish, implement, maintain, and enforce written policies and procedures reasonably designed to provide for governance arrangements that are clear and transparent, **clearly prioritize the safety and efficiency** of the covered clearing agency, and support the public interest requirements in Section 17A of the Exchange Act and the objectives of owners and participants."[10] In addition, according to the Release, "board members and management should not have conflicts of interest that could undermine the decision-making process within a covered clearing agency or interfere with fair representation and equitable treatment of clearing members or other market participants by a covered clearing agency."[11] However, the Proposed Rules stop short of requiring covered clearing agencies to resolve these conflicts.

At a minimum, the SEC should require clearing agencies to document and maintain policies and procedures governing the resolution of conflicts of interests that may impact certain decisions by the board of directors. For example, where a board member has material competing business interests with the clearing agency, the board must have in place policies and procedures for recusal. Not only is this consistent with the PFMI Report, but it is also the approach adopted by the CFTC.[12]

In the Release, the SEC indicates that it has declined to adopt such requirements because they are duplicative of existing Exchange Act requirements to clearing agencies and otherwise have been contemplated by the SEC's proposed Regulation MC.[13] This is not a valid justification for omitting such explicit requirements in the Proposed Rules, particularly for covered clearing agencies, which by the SEC's proposed definition pose special risks to the U.S. securities markets. Moreover, reliance on proposed Regulation MC[14] is misplaced as it only applies to clearing agencies that clear SBS. In addition, Regulation MC was proposed in October 2010 and was required by law to be adopted over

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9 For example, the OCC has 9 clearing member directors on its 19 member board. *See* Comment Letter from Craig S. Donohue, OCC, to the Board of Governors of the Federal Reserve System, Re: Board Proposal Regarding Financial Market Utilities (March 31, 2014), *available at* http://www.federalreserve.gov/SECRS/2014/April/20140401/R-1477/R-1477_033114_112201_564063302897_1.pdf. The Depository Trust & Clearing Corporation, the parent company of DTC, NSCC, and FICC, has 11 directors that represent clearing agency participants out of its 18 member board. *See* Letter to Participants of the DTC, NSCC, and FICC, Re: Nominations to the Board of Directors of The Depository Trust & Clearing Corporation (Dec. 19, 2013), *available at* http://www.dtcc.com/~/media/Files/pdf/2013/12/19/MBS20313.ashx.

10 79 Fed. Reg. 16,878 (emphasis added).

11 79 Fed. Reg. 16,879.

12 17 CFR 39.32(b)(7).

13 79 Fed. Reg. 16,947.

14 75 Fed. Reg. 65,881 (Oct. 26, 2010).

3 years ago; yet, there is no indication that the SEC intends to move forward on that proposal.[15]

Furthermore, to ensure that conflicts are appropriately mitigated and that the covered clearing agencies' governance arrangements clearly prioritize safety and efficiency, the SEC must require that independent directors be truly independent. To accomplish this objective, the SEC should clearly define independent directors to "exclude parties with significant business relationships with the [covered clearing agency], cross-directorships, . . . controlling shareholdings," as well as executives, officers, or employees of the covered clearing agency or its affiliate.[16]

In addition, the SEC must specify that independent directors **must support the objectives of customers and the public**, rather than simply the clearing members. Clearing members have their own interests to serve in making profits, which at times may conflict with a variety of important public interest considerations, including the need to support the stability of the broader financial system, to foster fair and efficient markets, and to serve the legitimate interests of relevant stakeholders. To help achieve their purpose of providing strong and independent oversight, and to serve as a check against potentially detrimental conflicts of interest, independent directors must be truly independent and required to support the interests of the public and customers.

Finally, governance arrangements at covered clearing agencies must foster accountability by the board and management. The Proposed Rules fail to do so and must be amended to require covered clearing agencies to clearly document the roles and responsibilities of the board of directors[17] and management, and implement governance arrangements that specify clear and direct lines of responsibility. This documentation should be disclosed to clearing agency members, the SEC, and the public. These requirements, adopted in the PFMI report and by the CFTC,[18] are necessary components of effective governance arrangements that promote individual responsibility and accountability.

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15 The other SEC proposals cited in the Release suffer from this same flaw and are more than three years old.

16 *See* PFMI Report, Explanatory Note 3.2.10 to Governance.

17 The roles and responsibilities of the board should include: "(a) establishing clear strategic aims for the entity; (b) ensuring effective monitoring of senior management (including selecting its senior managers, setting their objectives, evaluating their performance, and, where appropriate, removing them); (c) establishing appropriate compensation policies (which should be consistent with best practices and **based on long-term achievements, in particular, the safety and efficiency of the FMI**); (d) establishing and overseeing the risk-management function and material risk decisions; (e) overseeing internal control functions (including ensuring independence and adequate resources); (f) ensuring compliance with all supervisory and oversight requirements; (g) ensuring consideration of financial stability and other relevant public interests; and (h) providing accountability to the owners, participants, and other relevant stakeholders." PFMI Report, Explanatory note 3.2.8 on Governance (emphasis added).

18 17 CFR 39.32 (b)(4)-(6).

B. Risk Management: The SEC must ensure that the risk management framework of covered clearing agencies assigns responsibilities and accountability, is sufficiently independent, and includes a Chief Risk Officer.

To be successful, covered clearing agencies must adequately manage risk. The Proposed Rules require a covered clearing agency to establish, implement, maintain, and enforce written policies and procedures reasonably designed to maintain a sound risk management framework for comprehensively managing its risks. As proposed, a covered clearing agency's risk management framework must:

(i) Include risk management policies, procedures, and systems designed to identify, measure, monitor, and manage the range of risks that arise in or are borne by the covered clearing agency, that are subject to review on a specified periodic basis and approved by the board of directors annually;

(ii) Include plans for the recovery and orderly wind-down of the covered clearing agency necessitated by credit losses, liquidity shortfalls, losses from general business risk, or any other losses;

(iii) Provide risk management and internal audit personnel with sufficient authority, resources, independence from management, and access to the board of directors;

(iv) Provide risk management and internal audit personnel with a direct reporting line to, and oversight by, a risk management committee and an audit committee of the board of directors, respectively; and

(v) Provide for an independent audit committee.

According to the Release, a "covered clearing agency's policies and procedures [must] take a broader, more comprehensive approach to risk management."[19]

These requirements are necessary and appropriate for effective risk management, but the SEC must establish additional requirements to further ensure accountability and independence. First, consistent with the PFMI Report and CFTC regulations, the SEC should require the risk management framework at covered clearing agencies to "assign[] responsibilities and accountability for risk decisions, and address[] decision making in crises and emergencies."[20] Moreover, "[t]he reporting lines for risk management should be clear and separate from those for other operations of the [covered clearing agency], and

[19] 79 Fed. Reg. 16,881.

[20] PFMI Report, Key consideration 6 to Governance; *see also* 17 CFR 39.32(b)(8) &(9) (requiring covered derivatives clearing organizations to have governance arrangements that "[d]escribe procedures pursuant to which the board of directors oversees the chief risk officer, risk management committee, and material risk decisions;" and "[a]ssign responsibility and accountability for risk decisions, including in crises and emergencies").

there should be an additional direct reporting line to a non-executive director on the board via a chief risk officer."[21]

Second, the SEC must require that the board have a risk committee comprised of and led by a majority of independent directors. In addition, "[t]he committee should have a clear and public mandate and operating procedures and . . . have access to external expert advice."[22] The inherent conflicts of interest among those board members representing clearing members raise meaningful concerns, and the SEC must implement heightened measures to ensure that important risk management functions are appropriately insulated from such conflicts.

Third, consistent with CFTC regulations, the SEC must require that covered clearing agencies "have a chief risk officer who shall be responsible for implementing the risk management framework . . . and for making appropriate recommendations to the . . . risk management committee or board of directors, as applicable, regarding the [covered clearing agency's] risk management functions."[23] As indicated by the CFTC, a chief risk officer is industry "best practice."[24] Given the special concerns that covered clearing agencies raise with respect to significant concentration of risk, a designated risk officer at the executive level is an obvious and indispensable requirement.

C. Credit Risk and Margin: Model Validation Must Be Performed by an Independent Third Party.

The Proposed Rules require a covered clearing agency to require annual validation of its credit risk and margin models and for that validation to be performed by a qualified person who is free from influence from the persons responsible for the development or operation of the models or policies being validated so that the models can be candidly assessed. The Release notes that the SEC "considers that a person is free from influence when that person does not perform functions associated with the clearing agency's models (except as part of the annual model validation) and does not report to a person who performs these functions."[25]

The SEC's focus on independence is appropriate, but the standard proposed is inadequate. Credit risk and margining systems are absolutely critical to the systemic integrity of clearing agencies. If the systems work correctly, the financial resources of a clearing agency will only be needed for member defaults that occur simultaneously with extraordinary market conditions. This is the premise behind the clearing mandate in the Dodd-Frank Act.

Because these models are critical elements of the clearing system, they must be validated annually by a qualified and independent organization with no financial stake in

21 PFMI Report, Explanatory Note 3.2.14 to Governance.
22 PFMI Report, Explanatory Note 3.2.14 to Governance.
23 17 CFR 39.13(c).
24 78 Fed. Reg. 3,703.
25 79 Fed. Reg. 16,885.

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

the outcome. No employee of a covered clearing agency should be expected to resist the inevitable direct and indirect pressures of management who may be incentivized to achieve a less appropriate and independent outcome.

## III. As it finalizes all of its rules, the SEC should adhere to a number of core principles governing the economic analysis actually required under the securities laws.

A critically important aspect of the SEC's rulemaking process is the way in which it approaches economic analysis. This issue is fundamentally important because the SEC's approach to economic analysis affects **all** of its proposed rules, regardless of their specific substantive focus.

In reality, and as discussed in detail below, the SEC's statutory duty is narrow: it need not conduct a cost-benefit analysis for any of its rules, and its first priority in the rulemaking process is to protect investors and serve the public interest, not compromise the strength of its regulations to accommodate industry's often baseless cost concerns or speculative and hypothetical competitive issues, no matter how often claimed.

Nevertheless, even when the SEC has clearly fulfilled its limited statutory duty to consider the economic impact of its rules, representatives from industry have challenged proposed rules claiming—without merit—that the SEC failed to appropriately conduct what the industry calls "cost-benefit analysis." These attacks rest on a series of fundamentally flawed claims. For example, in challenging rules promulgated by the Commission, the industry has:

(1) greatly exaggerated the actual duty imposed on the Commission by its governing statutes, Section 2(b) of the Securities Act and Sections 3(f) and 23(a)(2) of the Exchange Act, in effect seeking to transform that limited duty into what they call "cost-benefit analysis," but which is in reality an "industry cost-only analysis;" and

(2) entirely disregarded the paramount statutorily required role of the public interest in the rulemaking process.

Accordingly, as the SEC finalizes the Proposed Rules, it is imperative that it adhere to a series of core principles governing the actual contours of its duty to consider the economic impact of its rules.

### A. Under the securities laws, the Commission has no statutory duty to conduct cost-benefit analysis; its far more narrow obligation is simply to consider certain enumerated factors.

Sections 3(f) and 23(a)(2) of the Exchange Act set forth the SEC's statutory requirement to "consider" a rule's impact on several specifically listed economic factors.[26]

[26] 15 U.S.C. §§ 78c(f), 78w(a)(2).

Specifically, Section 3(f) requires the SEC, after considering "the public interest" and the "protection of investors," "to consider . . . whether the action will promote efficiency, competition, and capital formation." Section 23(a)(2) requires the SEC to "consider among other matters the impact any such rule or regulation would have on competition," and to refrain from adopting the rule if it "would impose a burden on competition not necessary or appropriate in furtherance of the purposes of [the statute]."[27] The Exchange Act contains no language requiring a cost-benefit analysis and there is no basis for imposing any such requirement.

When Congress intends cost-benefit analysis to apply, it explicitly refers to "costs" and "benefits" and specifies the nature of the analysis.[28] And, when Congress wants agencies to be free from those constraints, it imposes a less burdensome requirement, thus giving overriding importance to particular statutory objectives.[29]

Moreover, Congress's careful choice of words in Sections 3(f) and 23(a)(2) and the case law construing similar provisions, make clear that the SEC has broad discretion in discharging its duty. The Supreme Court has long recognized that when statutorily mandated **considerations** are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty.[30]

Recently, the Court of Appeals for the District of Columbia confirmed these principles in *National Association of Manufacturers v. SEC*.[31] In rejecting the industry's attack on the SEC's economic analysis in its conflict minerals rule, the Court articulated the basic principle that no agency is required to conduct a "rigorous, quantitative economic analysis" unless a statute explicitly requires it to do so, and no such statute requires the SEC to do so. In addition, the Court explained that no agency has the authority to second-guess the judgments about costs and benefits that Congress has already made. There the Court found that Congress had already determined that the costs of the rule were

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27 Better Markets has set forth a comprehensive analysis regarding the scope of the SEC's duties under the securities laws in BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf. The report is incorporated by reference as if fully set forth herein.

28 *See American Textile Mfrs. Inst., Inc. v. Donovan*, 452 U.S. 490, 510-512 & n. 30 (1981) (stating that "Congress uses specific language when intending that an agency engage in cost-benefit analysis" and citing numerous statutory examples).

29 *See Whitman v. American Trucking Ass'ns., Inc.*, 531 U.S. 457, 471 (2001) (holding that a statute "unambiguously bars cost considerations"); *see also Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1039 (D.C. Cir. 2012) (statutes in which agencies must "consider" the "economic" impact or "costs" do not require cost-benefit analysis); *Cent. Ariz. Water Conservation Dist. v. EPA*, 990 F.2d 1531, 1542 n.10 (9th Cir. 1993) (language in 42 U.S.C. § 7491(g)(1) requiring "consideration" does not require a cost-benefit analysis).

30 *Sec'y of Agric. v. Cent. Roig Ref. Co.*, 338 U.S. 604, 611 (1950).

31 *Nat'l Ass'n of Mfrs. v. SEC*, No. 13-cv-5252, 2014 U.S. App. LEXIS 6840 (D.C. Cir. Apr. 14, 2014); *see also* Brief of Better Markets as *Amicus Curiae* filed with the DC Circuit on October 30, 2013 (incorporated by reference as if fully set forth herein).

necessary to further the goals of "peace and security in the Congo." Any attempt by the SEC to revisit or second-guess this judgment would have put the agency in an "impossible position."

Finally, the Court highlighted yet another fundamental problem with cost-benefit analysis, observing that it forces courts to make a pointless "apples-to-bricks" comparison whenever benefits—such as peace, security, and lives saved—cannot be framed in terms of dollars and cents. The decision in *National Association of Manufacturers* followed the holding of the D.C. Circuit last summer in *Investment Company Institute v. CFTC*, which similarly recognized that the CFTC need not conduct a rigorous, quantitative cost-benefit analysis when it adopts derivatives rules under the Commodity Exchange Act.[32]

Like the CFTC's obligation under the CEA, the Commission's duty under the securities laws stands in sharp contrast to the statutory provisions in which Congress explicitly mandates a netting or specific balancing of costs and benefits.

The plain fact is that the SEC has no statutory or other obligation[33] to quantify costs or benefits,[34] weigh them against each other,[35] or find that a rule will confer a net benefit before promulgating it. The rationale for this flexible obligation in the law is clear: Requiring the SEC to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives.

The industry's desire to have its costs prioritized over all other costs (what they incorrectly refer to as "cost-benefit analysis") does not change the law or its underlying policy.

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32 *Inv. Co. Inst. v. CFTC*, 720 F.3d 370 (D.C. Cir. 2013).

33 Indeed, there is no other law which would subject the Commission to a cost-benefit duty. The APA does not require such an analysis, *Vill. of Barrington v. Surface Transp. Bd.*, 636 F.3d 650, 670-671 (D.C. Cir. 2011), and the Executive Orders on cost-benefit analysis exclude the Commission and other independent agencies, Executive Order 13,579, 76 Fed. Reg. 41,587 (July 14, 2011); Executive Order No. 13,563, 76 Fed. Reg. 3,821, § 7 (Jan. 21, 2011); Executive Order 12,866, 58 Fed. Reg. 51,735, § 3(b) (Oct. 4, 1993).

34 *Cf.* 42 U.S.C. § 300g-1(b)(3) (imposing a duty on the Environmental Protection Agency to use analysis of specific factors including the "[q]uantifiable and nonquantifiable health risk reduction benefits," the "[q]uantifiable and nonquantifiable costs," and "[t]he incremental costs and benefits associated with each alternative."). Courts have repeatedly held that an agency need not quantify the costs and benefits of a rule when a statute does not require it. *See, e.g., FMC Corp. v. Train*, 539 F.2d 973, 978-979 (4th Cir. 1976) (finding that 33 U.S.C. §§ 1314(b)(1)(B), (b)(2)(B) and § 1316 do not require quantification of the benefits in monetary terms). In fact, the D.C. Circuit has explicitly recognized that even in a cost-benefit analysis an agency's "predictions or conclusions" do not necessarily need to be "based on a rigorous, quantitative economic analysis." *Am. Fin. Services Ass'n. v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985); *see also Pennsylvania Funeral Directors Ass'n v. FTC*, 41 F.3d 81, 91 (3d Cir. 1994) (recognizing that "much of a cost-benefit analysis requires predictions and speculation, in any context," and holding that the "absence of quantitative data is not fatal").

35 Even when a statute refers to "costs" and "benefits," Courts refuse to impose a duty to conduct cost-benefit analysis absent language of comparison in the statute. *See Weyerhaeuser Co. v. Costle*, 590 F.2d 1011, 1045 (D.C. Cir. 1978); *see also Am. Petroleum Inst. v. EPA*, 858 F.2d 261, 265 & n.5 (5th Cir. 1988); *Reynolds Metal Co. v. EPA*, 760 F.2d 549, 565 (4th Cir. 1985).

B. The SEC must be guided first and foremost by the public interest and the protection of investors as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry.

The SEC's preeminent duty when promulgating rules is to protect investors and the public interest. The agency was established for the purpose of implementing the securities laws, and therefore its primary duty is to achieve the legislative objectives of those laws, which are first and foremost to protect investors and the public interest from fraud, abuse, and manipulation in the securities markets. As is evident from the securities laws themselves, their legislative history, and the specific delegations of rulemaking authority, the public interest and protection of investors is a key consideration in the SEC's rulemaking process. Indeed, Section 3(f) of the Exchange Act explicitly refers to "the protection of investors" and "the public interest," but do not mention any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements.[36]

The SEC's duty to protect investors and the public interest has renewed importance in light of the 2008 financial crisis. The financial crisis is a powerful reminder of the need to remain focused on the core purposes of securities regulation and the Commission's overriding duty to protect the public, investors, and the integrity of the markets. The Supreme Court's admonition about the importance of raising standards of conduct to the highest possible level following the Great Depression applies with equal force today:

> It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail in every facet of the securities industry.[37]

If these goals are subordinated to industry concerns over the costs of regulation in the rulemaking process, then proposed regulations will have little chance of protecting investors, as intended by the securities laws. Thus, in promulgating the Proposed Rules, the SEC must be guided by the preeminent concerns of the public interest and the protection of investors, not the burdens of regulation on industry.

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36 *Cf.* 42 U.S.C. § 300g-1(b)(3)(C) (requiring analysis of certain costs of safe drinking water regulations including costs that "are likely to occur solely as a result of compliance with the maximum contaminant level, including monitoring, treatment, and other costs"); 42 U.S.C. § 6295(d) (1976 ed., Supp. II ) (requiring a weighing of the economic impact on manufacturers and the savings in operating costs as "compared to any increase in the price of, or in the initial charges for, or maintenance expenses of, the covered products which are likely to result").

37 *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-87 (1963) (quoted authorities omitted).

C. For any rule promulgated in accordance with and in furtherance of the Dodd-Frank Act, the ultimate public interest and investor protection consideration is implementing the reforms that Congress passed to provide for a safer and sounder financial system and to prevent another financial crisis.

The statutory authority for the Proposed Rules is the Dodd-Frank Act. The SEC must therefore consider and give proper weight to the overriding goal that Congress intended to achieve when it passed the comprehensive, interrelated law, and in terms of the enormous benefit that the rules collectively will provide to the public. That goal is to prevent another financial collapse and economic crisis, and that benefit is to avoid the economic costs, hardships, and human suffering that would inevitably accompany such disastrous events.

The dollar cost alone of the financial collapse and still-unfolding economic crisis is conservatively estimated to be in the trillions. A study by Better Markets estimates that those costs will exceed $12.8 trillion.[38] In addition, the Government Accountability Office has recently issued the results of a study on the costs of the crisis, observing that "the present value of cumulative output losses [from the crisis] **could exceed $13 trillion.**"[39] Therefore, as the SEC considers the public interest and the protection of investors under Sections 3(f) and 23(a)(2), it must continue to consider, above all, the benefits of the entire collection of reforms embodied in the Dodd-Frank Act, of which any specific rule is but a single, integral part.

Congress passed the Dodd-Frank Act knowing full well that it would impose significant costs on industry, yet it determined those costs were not only justified but necessary to stabilize our financial system and avoid another financial crisis. Those costs include the elimination of extremely profitable lines of business as well as significant and ongoing compliance costs. A leading example is the establishment of the new, comprehensive regulatory regime for swaps. It will require the financial industry to incur significant costs arising from new personnel and technology, ongoing compliance, margin and collateral, and reduced revenues and profits.

However, the financial reform law and the rules implementing it do not, in fact, add any incremental costs (or, if they do, those costs are *de minimis*). Rather, they reallocate costs so that industry bears them in a regulated environment that **prevents** financial

[38] *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_0.pdf, incorporated here as if fully set forth herein.

[39] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013) (released Feb. 14, 2013), *available at* http://gao.gov/assets/660/651322.pdf (emphasis added).

failure and bailouts. As a result, the public and society are spared the massive costs of responding to economic crises after the fact.[40]

Congress fully understood this. It knew that re-regulation would impose costs on the industry, in some cases totaling billions of dollars. The Dodd-Frank Act reflects Congress's unflinching determination to shift the costs of de-regulation and non-regulation of the financial industry back to the industry from a society that has paid and continues to pay the bill for industry's unregulated excesses. In substance, Congress conducted its own cost-benefit analysis and concluded that the enormous collective benefits of the law far exceeded the costs and lost profits that industry would have to absorb.[41]

Against the backdrop of the worst financial and economic crises since the Great Depression, it is inconceivable that Congress would enact sweeping reforms and then allow the implementation of those reforms to hinge on the outcome of a biased, one-sided cost-benefit analysis that ignored the overriding purpose of the new regulatory framework—and that gave controlling weight to cost concerns from the very industry that precipitated the crisis and inflicted trillions of dollars in financial damage and human suffering across the country.

Indeed, had Congress wanted the financial regulatory agencies to conduct cost-benefit analysis prior to promulgating the rules under the Dodd-Frank Act, it would have clearly said so. Congress passed the Dodd-Frank Act fully aware of the specific economic analysis provisions in the federal agencies' governing statutes—like Sections 3(f) and 23(a)(2) of the Exchange Act—and fully aware of how to impose a cost-benefit analysis requirement. Yet, it made no changes to those provisions, thereby affirming congressional intent that those specific provisions should control as they were originally written and in accordance with long-standing Supreme Court precedent.

## IV. <u>The Release shows that the SEC complied with its duty under the Exchange Act but could do much more to clarify and streamline its economic analysis.</u>

The Release shows that the SEC has considered the economic impact of the Proposed Rules under 3(f) and 23(a)(2) of the Exchange Act.[42] However, the SEC can still enhance its discussion of economic analysis in several respects.

### A. <u>The SEC complied with its duty under the Exchange Act.</u>

In the Release, the SEC set forth its statutory duty[43] and appropriately considered and explained how various aspects of the Proposed Rules would affect efficiency,

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40 *See* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf.

41 *Id.* at 43.

42 79 Fed. Reg. 16,933-69.

43 79 Fed. Reg. 16,935.

competition, and capital formation.[44] This is what the securities laws require, and by considering the specified factors, the SEC has fulfilled its duty with respect to economic analysis.

B. However, the SEC must ensure that its economic consideration is limited to its narrow duty under the Exchange Act, and it must highlight other important factors, including investor protection and avoiding another financial crisis

First, the SEC should be more limited in its approach, adhering more closely to the statutory requirement and expressly disavowing any obligation to conduct cost-benefit analysis. The SEC should carefully avoid undertaking a general cost-benefit analysis, or any similar approach in which agencies determine and quantify costs and benefits, net them against one another, and adopt the least costly rule. This type of analysis is not required by the Exchange Act, it poses a threat to the implementation of Congress's policy goals, and it wastes agencies' resources without producing accurate or useful results. In fact, consideration of costs and benefits beyond those specifically tied to the relevant securities law provisions tends to mislead the public and the Commission by overemphasizing easily quantifiable costs and neglecting important but unquantifiable, benefits.

At a minimum, the SEC should emphasize its statutory duty under the Applicable Statutes, and it should explicitly assert that it is not required to perform a cost-benefit analysis, quantify or compare costs and benefits, or perform any analysis that exceeds the requirements in the Exchange Act. Moreover, as mentioned above, there is no need for the agency to quantify or "determine" the Proposed Rules' costs and benefits.

Second, to the extent the SEC believes it is desirable to consider specific costs and benefits, it should clearly tie those costs and benefits to the three statutory factors (efficiency, competition, and capital formation) to avoid any possible misunderstanding. Throughout the Release, the SEC discusses specific costs and benefits associated with the Proposed Rules. Assuming that particular costs and benefits are at all relevant to the SEC's required economic consideration, the agency should more clearly set forth how those costs and benefits are directly related to protecting investors or the public or to efficiency, competition, or capital formation.

Finally, the SEC should more clearly highlight the primary and overriding purpose of the securities laws—to protect investors—and the role of the Proposed Rules in accomplishing that purpose. Similarly, the SEC should more clearly highlight the collective benefit of the Dodd-Frank Act reforms, of which the Proposed Rules are an integral part. That overarching benefit is preventing another devastating financial crisis.

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[44] *See, e.g.,* 79 Fed. Reg. 16,951 ("Additionally, the Commission preliminarily believes that consistency with international regulatory frameworks, as embodied by the standards set forth in the PFMI Report, which may promote the integrity of cleared markets, could have substantial effects on competition, efficiency, and capital formation.").

**CONCLUSION**

We hope that our comments are helpful.

Sincerely,

Dennis M. Kelleher

Dennis M. Kelleher
President & CEO

Stephen Hall
Securities Specialist

Katelynn Bradley
Attorney

Caitlin Kline
Derivatives Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
shall@bettermarkets.com
kbradley@bettermarkets.com
ckline@bettermarkets.com

www.bettermarkets.com