January 22, 2013

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

Re: Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security- Based Swap Participants and Capital Requirements for Broker-Dealers (RIN: RIN 3235–AL12)

Ladies and Gentlemen:

Better Markets, Inc.[1] appreciates the opportunity to comment on matters identified in the above-captioned proposed rules ("Release," "Security-Based Swaps Rules") of the Securities Exchange Commission ("SEC," "Commission"). The Release addresses issues relating to capital and risk management by Security-Based Swap Dealers ("SBSDs"), Major Security-Based Swaps Participants ("MSBSPs") and capital requirements for Broker-Dealers ("BDs") in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

INTRODUCTION

Derivatives played a central role in the financial crisis. Inadequate capital and margin combined with a lack of transparency led to a complete breakdown of markets, with sudden collateral calls bringing financial institutions to their knees. This rulemaking seeks to address this vulnerability by ensuring large players in the Security-Based Swaps ("SBS") markets hold adequate capital and margin against their derivatives exposures.

The proposed rules make are a good attempt at setting capital and margin requirements in such a way that they contain systemic risk. However, there are several crucial respects in which the proposals must be strengthened if they are to fulfill the statutory requirements of the Dodd-Frank Act.

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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.

SUMMARY OF COMMENTS

If two entities engage in the same risky SBS activities, they should not have asymmetric capital requirements simply because one is a broker-dealer and the other is not.

The proposed capital requirements for SBSDs vary depending on whether the entity is also a BD. However, the question of whether a firm acts as a broker in some SBS transactions has no bearing on the amount of regulatory capital it should be required to maintain against its own SBS dealing activities.

The proposal by the SEC to allow certain market participants to calculate their own risk weightings for regulatory capital should be replaced by a standard model.

Under the proposal, some firms will be approved by the Commission to use proprietary models to calculate risk and haircuts for the purposes of establishing regulatory capital levels, yet others will not. This would create a multi-tiered system which would help to reinforce the existing oligopoly in derivatives and create dangerous incentives for some firms to game the system by calculating haircuts using unrealistic assumptions.

Risk weighting is a failed regulatory strategy.

There is abundant evidence that the strategy of setting regulatory capital ratios relative to risk-weighted assets has been an abysmal failure. Regulatory capital ratios failed to measure just how vulnerable various financial institutions were to losses in the run up to the crisis. Risk-weighting ought to be replaced with simpler rules, with lower leverage ratios that reflect the restricted liquidity available to non-bank SBSDs (as recognized in the Release).[2] If risk-weighting is kept as an approach, it must be framed in a way that properly accounts for tail risk.

Netting derivatives exposures when calculating potential losses is an unsound risk management practice.

Unlike securities markets where liquidity conditions for fungible securities tend to be relatively consistent, SBS liquidity conditions can vary widely even for contracts that appear fungible, especially for uncleared SBS. Therefore, even if two positions appear to offset one another, the liquidity conditions, replacement costs, and counterparty credit risk may vary considerably.[3] If an SBSD operates a balanced book, the net exposure of the portfolio will appear very small. However, if a counterparty to a significant portion of one side of that book defaults, the dealer faces a potentially large replacement cost, or else is left completely unhedged with respect

[2] Release 70218.

[3] Especially in the case of uncleared swaps, but even for offsetting cleared swaps if they are cleared through different DCOs.

to the positions the defaulting contracts previously offset. The net measure of derivatives exposures should be replaced by a gross measure throughout the proposed rules.

VaR-based models are wholly inadequate as a method for calculating capital charges.

The Proposed Rule[4] retains the pre-crisis VaR-based procedures under which security-based swap dealers estimate the market risk of their trading book, and then convert that estimate into market risk equivalent assets against which regulatory capital must be held. In short, it is a continuation of the status quo, and inadequate for the new, safer security-based swaps regime required under Dodd-Frank.

The SEC has fulfilled its duties by considering the economic impact of the Proposed Rule under Sections 3(f) and 23(a)(2) of the Exchange Act, but its approach should be refined in two important respects.

The SEC clearly satisfied its duty under the securities laws to consider whether the Proposed Rule would promote efficiency, competition, and capital formation. However, the SEC should more closely adhere to the statutory requirement—namely the duty simply to consider the specified factors—rather than attempting the unnecessary, burdensome, and imprecise task of reviewing costs and benefits on a more comprehensive basis. Further, the SEC must more fully set forth the Proposed Rule's connection to the overriding purposes of the Dodd-Frank Act and the larger benefits of establishing a safer and more sound financial system, thereby avoiding another financial crisis.

DISCUSSION OF PROPOSED RULE PROVISIONS

If two entities engage in the same risky SBS activities, they should not have asymmetric capital requirements simply because one is a broker-dealer and the other is not.

The proposed capital requirements for SBSDs vary depending on whether the entity in question is also a BD. However, the question of whether a firm acts as a broker in some SBS transactions has no bearing on the amount of regulatory capital it should be required to maintain against its own SBS dealing activities. By giving precedence to one or the other group, the Commission would needlessly distort the incentives for firms to offer or specialize in certain market services, making form more important than substantive activities.

A separate standard for BD SBSDs and non-BD SBSDs needlessly complicates the regulatory framework. If the risk profile of the SBS activities undertaken by two separate entities, one of whom happens also to be a BD, is identical, the capital maintained against those risks should also be identical. Both have the same exposure, so both need the same

[4] Federal Register, Vol. 77, No. 169, 52977.

protections in the form of readily available, liquid assets that can be used during market stress. The Dodd-Frank Act set out to create a new financial system with less systemic risk and a more even playing field. Entrenching the pre-crisis advantages of certain groups of market participants is not appropriate under the new system.

The proposal by the SEC to allow certain market participants to calculate their own risk weightings for regulatory capital should be replaced by a standard model.

The proposed capital requirements for SBSDs vary depending not only on whether the entity in question is a BD, but also on whether it is approved by the Commission to use its own internal models to calculate risk and haircuts for the purposes of establishing regulatory capital levels. In theory, this is a logical approach, reflecting the fact that different types of entities will generally represent different risk profiles. In reality, however, it creates a multi-tiered system which will help to reinforce the existing oligopoly in the derivatives markets and create dangerous incentives for some firms to game the system by calculating haircuts using unrealistic or "aggressive" assumptions.

This asymmetric system is further skewed by the proposed increased capital requirements of $1bn in net capital and $5 billion in tentative net capital for ANC BDs. In essence, this merely entrenches the position of the largest BDs while creating a barrier to entry for new competitors.

By creating a privileged group of market participants who are allowed to use their own proprietary models to calculate haircuts (the "ANC Entities"), the SEC would be catering to a single powerful group of market participants to the detriment of other market participants. Moreover, as discussed below, the VaR-based models that would be employed by those firms may tick all the boxes in the short term but could lead to disastrous results over time.

In short, permitting ANC Entities to use their own proprietary risk models would only be justifiable were there good reason to believe such entities are capable of making optimal judgments about risk. The conflicts of interest inherent in such a set-up, as well as the catastrophic failure by significant market participants to accurately measure risk in the run up to the recent financial crisis, prove beyond doubt that this is simply not the case.

The rationale given in the Release for allowing ANC entities to calculate their own capital requirements is flawed. In support of the proposal to allow ANC entities to self-calculate, the Release cites "their large size, the scale of their custodial activities, and the potential substantial leverage they may take on if they become more active in the security-based swap markets under the Dodd-Frank Act reforms."[5] However, for the very reasons the Commission cites, these entities are the most

[5] Release at 70216.

systemically risky, and some failed most spectacularly, and must therefore be held to a **higher** standard of oversight.

Nor do the other considerations in the Release sufficiently compensate for this weakness. First, the Commission argues that the leeway granted to ANC Entities to calculate their own capital charges is offset by the higher absolute minimum capital requirements they are subject to ($1 billion as opposed to $20 million). However, the higher absolute minimum capital requirement is no substitute for proper relative capitalization with respect to the actual size of SBS activities that the entity in question is engaged in. The Commission notes that many large BDs already easily exceed the $1 billion capital threshold. Therefore, if the capital they hold is not commensurate with the risks they are taking, the fact that its absolute value is high is of little comfort. In fact, if anything the approach **increases** systemic risk, by ensuring that precisely the largest, most systemically important non-bank SBSDs are the ones allowed to use potentially unsound models for calculating capital.

Risk weighting is a failed regulatory strategy.

There is abundant evidence that the strategy of setting regulatory capital ratios relative to risk-weighted assets has been an abysmal failure. As we have shown in a letter to the Federal Reserve Board, Washington Mutual, Wachovia, Citigroup, and Bank of America appeared well capitalized up until the moment that they either failed or were rescued from failure.[6] Regulatory capital ratios failed to measure just how vulnerable those banks were to losses and systemically risky collapse. There is also substantial regulatory and academic criticism of the risk-weighting approach.[7] The same reasoning that applied with respect to those banks is equally valid for non-bank SBSDs, including those that are also BDs.

Risk-weighting ought to be replaced with simpler rules, with lower leverage ratios that reflect the restricted liquidity available to non-bank SBSDs (as recognized in the Release).[8] However, given that risk-weighting is likely to continue in place for the foreseeable future, there are elements of the proposed risk-weighting scheme that ought to be improved if it is not replaced or prior to it being replaced. Specifically, tail

6 Better Markets Comment Letter "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule," (October 22, 2012) *available at* http://www.federalreserve.gov/SECRS/2012/November/20121102/R-1442/R-1442_102212_110339_429542953578_1.pdf.

7 *See, e.g.*, A. Haldane (2012). The dog and the Frisbee, *available at* www.bankofengland.co.uk/publications/Pages/speeches/default.aspx; M. Hellwig (2010). Capital Regulation after the crisis: Business as Usual?, *available at* http://ssrn.com/abstract=16456224; T. Hoenig, op. cit.

8 Release 70218.

risk must be accounted for in a much more satisfactory manner (see discussion below).

Netting derivatives exposures when calculating potential losses is an unsound risk management practice.

Unlike securities markets where liquidity conditions for fungible securities tend to be relatively consistent, SBS liquidity conditions can vary widely even for contracts that appear fungible, especially for uncleared SBS. Therefore, even if two positions appear to offset one another, the liquidity conditions, replacement costs and counterparty credit risk may vary considerably.[9] If an SBSD operates a balanced book, the net exposure of the portfolio will appear very small. However, if a counterparty to a significant portion of one side of that book defaults, the dealer faces a potentially large replacement cost, or else is left completely unhedged with respect to the positions the defaulting contracts previously offset.

Because the risk calculations used under the proposed system rely primarily on net exposures as determined under master netting agreements, they are likely to understate actual exposures and the risk they pose for large SBSDs. This will mean that insufficient capital will be required to back up the derivatives operations of large SBSDs and BDs (in particular, the uncleared portion). This can be seen by considering the way derivatives dealers actually behave.

Suppose that dealer A has in the money derivatives exposure to other dealers of \$100. Suppose that A's counterparties have in the money derivatives exposure to A of \$200. Assume that there are master netting agreements between A and its counterparties. Under the Proposed Rule, \$100 would be used as the measure of A's net exposure.

However, there is good reason to believe that this measure of exposure does not reflect the risks posed by A's derivatives book, and that the measure of risk to the dealer should be at least \$200. For if A's derivatives counterparties suspect that A will have difficulty meeting its future obligations, those counterparties will take steps to reduce all their exposures to A.

Counterparty actions to reduce gross exposure can take several forms. A's counterparties can try to novate their uncleared contracts to other dealers, who thereby assume the risk. Novation is common industry practice. But if the volume of novation is taken as a signal of A's weakness, other dealers may refuse. Their refusal to novate will amplify the perception of weakness.

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9 Especially in the case of uncleared swaps, but even for offsetting cleared swaps if they are cleared through different DCOs.

A's counterparties may also increase margin calls on their in the money contracts, or ask A to close out contracts (another industry practice). These actions will deplete A's collateral and cash resources.

The risk posed by a large uncleared derivatives book is therefore not accurately measured by its net exposures. If the dealer gets into trouble, its counterparties will not calmly wait until it fails. Instead, they will do everything they can to eliminate **any** exposure to the dealer. And this can quickly lead to runs, failure, and financial market spillovers.

For this reason, the risk margin amount is not a suitable baseline for capital calculations when it comes to uncleared SBS. A more inclusive measure should be used, which reflects the fact that even in a hedged book counterparty risk still remains on both sides of the hedge. A better measure of the risk faced by dealers, tied to **gross** exposure, is therefore needed.

VaR-based models are wholly inadequate as a method for calculating capital charges.

As argued above, permitting ANC entities to set their own haircuts based on internal risk models raises the problem of conflicts of interest, among others. Individual ANC entities could seek to reduce their regulatory capital requirements through underestimation of the haircuts. It is unlikely that the SEC would have the capacity to closely examine, duplicate, and back-test these estimates (especially in real time or, worse, during the gathering storm of a crisis and a volatile market). Therefore capital charges against these exposures could be reduced below the level anticipated by this regulation.

Therefore, to prevent them from being gamed, capital requirements for these exposures should **not** be calculated by ANC entities themselves. This is especially the case in light of the fact that the internal models would depend heavily or even entirely on VaR calculations.[10] The reliance on bank VaR-based models to estimate trading book risk and capital requirements asks for a repetition of past miscalculations and/or gaming.

The Proposed Rule retains the pre-crisis VaR-based procedures under which security-based swap dealers estimate the market risk of their trading book, and then convert that estimate into market risk equivalent assets against which regulatory capital must be maintained.[11] In short, it is a continuation and preservation of the status quo, and inadequate for the new, safer security-based swaps regime envisaged under Dodd-Frank.

[10] Release at 70216.

[11] Federal Register, Vol. 77, No. 169, 52977.

There are several difficulties with this approach. First, it provides no way for regulators or market participants to judge whether ANC entities' calculations of "market risk" are meaningful or not. BDs and SBSDs have a financial incentive to keep the values low. No one can evaluate their estimates, since they run the models and no one else is truly familiar with them.

The recent decision of Morgan Stanley to recalibrate its VaR model is a case in point.[12] The change reduced the bank's average VaR in the third quarter of 2012 by approximately one third, compared to the value that would have been reported before the model was changed. Does this reflect a better measurement of VaR, or does it reflect an intent to economize on regulatory capital requirements? Can anyone outside Morgan Stanley answer this question with confidence?[13] While the facts still are not clear, a version of this also appears to have happened in the JP Morgan Chase infamous $7 to $9 billion London "Whale" losses.

Second, even if ANC entities did not have a significant conflict of interest when running their risk models, there is little reason to believe that the VaR-based approach successfully measures risk. For example, in the run up to financial crisis, when the five stand-alone investment banks were rapidly increasing their leverage, their Unit VaR measures did not reflect increasing risk to the banks or to the financial system.[14] Similarly, AIG reported a very low "capital markets trading" VaR immediately prior to the financial crisis.[15]

Several commentators from within the derivatives world have made it clear they consider VaR to be an inadequate tool. For example, David Einhorn, founder of Greenlight Capital, has stated that VaR is "relatively useless as a risk-management tool and potentially catastrophic when its use creates a false sense of security among senior managers and watchdogs. This is like an air bag that works all the time, except when you have a car accident."[16] Additionally, a former Morgan Stanley risk manager has stated that "[VaR-based] Risk modeling didn't help as much as it should have,"[17] and NYU's Nassim Taleb has labeled VaR "a fraud."[18]

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12 "M Stanley shows the 'flaky' side of value at risk model", Financial Times, October 19, 2012.

13 There is also the risk of an inherent bias to lower VaR,in its construction. See "The Importance of Excel," Baseline Scenario, February 9, 2013, *available at* http://baselinescenario.com/2013/02/09/the-importance-of-excel/ .

14 T. Adrian and H. Shin (2012). Procyclical Leverage and Value-at-Risk. Federal Reserve Bank of New York Staff Report no. 338, *available at* http://www.newyorkfed.org/research/staff_reports/sr338.pdf.

15 M. Wacek (2008). AIG and the Future of Enterprise Risk Management, Society of Actuaries *available at* www.soa.org/library/essays/rm-essay-2008-wacek.pdf.

16 J. Nocera (2009). Risk Mismanagement, New York Times *available at* http://www.nytimes.com/2009/01/04/magazine/04risk-t.html?pagewanted=all&_r=0.

17 *Id.*

18 *Id.*

Instead of relying on failed risk modeling techniques to account for the risks posed by SBSDs, the Commission should apply the standardized requirements across the board and ensure that they are sufficiently calibrated to reflect the demonstrated vulnerabilities of broker dealers active in the SBS markets. Any VaR-based model will fail to adequately account for tail risk. Yet it is that very tail risk that is at issue when it comes to protecting the financial system from another derivatives-fueled collapse.

DISCUSSION OF ECONOMIC ANALYSIS

The statutory standard.

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.[19] 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]."

The persistent and unfounded criticisms from industry regarding economic analysis.

Even when the SEC has clearly fulfilled its 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 SEC, the industry has:

(1) greatly exaggerated the actual duty imposed on the SEC by its governing statutes, Sections 3(f) and 23(a)(2) of the Exchange Act, in effect seeking to transform that limited duty into an "industry cost-only analysis;"

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

(3) indefensibly ignored the enormous cost of the financial crisis and the larger collective benefit of all rules designed to help prevent a recurrence of that crisis or something far worse.[20]

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[19] 15 U.S.C. §§ 78c(f), 78w(a)(2).

[20] *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.pdf; *see also* U.S.

Core principles that must apply to the SEC's consideration of the protection of investors and the public and efficiency, competition, and capital formation.

When analyzing these attempts to undermine financial reform on what industry claims to be cost-benefit grounds, it is vitally important to bear in mind several core principles that accurately define the true nature and scope of the obligation that the SEC has when considering the economic impact of its rules.

1. *Under the securities laws, the SEC has no statutory duty to conduct cost-benefit analysis; in fact, its far more narrow obligation is simply to consider certain enumerated factors.*

Sections 3(f) and 23(a)(2) of the Exchange Act impose a limited obligation on the SEC simply to "consider" the protection of investors and the public as well as efficiency, competition, and capital formation. [21] It contains no language requiring a cost-benefit analysis and there is no basis for imposing any such requirement (and certainly none for an industry cost-only analysis, which is what the industry is really seeking).

When Congress intends cost-benefit analysis to apply, it explicitly refers to "costs" and "benefits" and specifies the nature of the analysis.[22] 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.[23] This latter type of economic impact obligation characterizes the SEC's statutory duty, and it stands in sharp contrast to the statutory provisions in which Congress explicitly mandates a netting or specific balancing of costs and benefits, let alone mentions "costs" and "benefits."

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

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GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013), *available at* http://gao.gov/assets/660/651322.pdf.

21 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. In addition, Better Markets has recently filed an *amicus curiae* brief in support of the SEC on the agency's statutory duties in *American Petroleum Inst. v. SEC*, No. 12-1398 (DC Cir. Oct. 10, 2012). Both the report and *amicus* brief are incorporated by reference as if fully set forth herein.

22 *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).

23 *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).

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.[24]

The plain fact is that the SEC has no statutory or other obligation[25] to quantify costs or benefits,[26] weigh them against each other,[27] 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 falsely refer to as "cost-benefit analysis") does not change the law, the reasoned basis for the law, or the underlying policy.

2. *The SEC must be guided 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

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

25 Indeed, there is no other law which would subject the SEC 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 SEC 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).

26 *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").

27 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).

explicitly refers to "the protection of investors" and "the public interest," but does not mention any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements.[28]

Moreover, the SEC's duty to protect investors and the public interest has renewed importance in light of the 2008 financial crisis. Indeed, the financial crisis is a powerful reminder of the need to remain focused on the core purposes of securities regulation and the SEC'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.[29]

If these goals are subordinated to industry concerns over the costs of regulation in the rulemaking process, then the reforms embodied in the Dodd-Frank Act will have little chance of protecting our markets and our economy from the ravages of another financial crisis. Thus, in promulgating rules under the Dodd-Frank Act, 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.

This, after all, is why the SEC was created, and its overriding mission has not changed.

3. *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 Rule 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

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[28] *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").

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

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.[30] In addition, the Government Accountability Office has just 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.**"[31] 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, including the Proposed Rule, is but a single, integral part.

Congress's resolve to prevent another massively costly financial crisis clearly overrides any industry-claimed cost concerns under the Dodd-Frank Act.

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 failure and bailouts. As a result, the public and society are spared the massive costs of responding to economic crises after the fact.[32]

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

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30 *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.

31 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).

32 *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.

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.[33]

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 intended.

In short, the following analytical framework must guide any consideration of the economic impact of rules implementing the Dodd-Frank Act, or any rules that are promulgated within the broader Dodd-Frank Act context:

- Congress's ultimate objective in the Dodd-Frank Act was to prevent another crisis and the massive costs it would inflict to our financial system, taxpayers, investors, economy, and country;

- The Proposed Rule is an integral component of the overall body of reforms that Congress envisaged to achieve this objective; and

- The costs of compliance and reduced profits that industry may have to absorb by virtue of the Proposed Rule, as well as the entire Dodd-Frank Act, were considered by Congress in passing the law and determined to pale in comparison with the benefits of preventing another crisis—a benefit that can be valued at over $12.8 trillion.

The Application of Sections 3(f) and 23(a)(2) in the Release.

The Release shows that the SEC has considered the economic impact of the Proposed Rule under Sections 3(f) and 23(a)(2). However, the SEC should more closely adhere to the statutory requirement, namely the duty simply to consider the specified

[33] *Id.* at 43.

factors, rather than attempting to review costs and benefits on a more comprehensive basis. Further, the SEC must more fully explain the Proposed Rule's connection to the overriding purposes of the Dodd-Frank Act and the larger benefits of establishing a safer and sounder financial system and avoiding another financial crisis.

1. The SEC complied with Sections 3(f) and 23(a)(2).

The SEC appropriately identified both of the statutory provisions applicable to its economic considerations[34] and explained how various aspects of the rule would effect the specifically enumerated factors in those provisions.[35] This is what the Exchange Act requires, and by considering the specified factors, the SEC has fulfilled its duty with respect to economic analysis.

The SEC must ensure that its economic consideration is limited to its narrow duty under Sections 3(f) and 23(a)(2).

The SEC should carefully avoid undertaking a 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 Sections 3(f) and 23(a)(2), it poses a threat to the implementation of Congress's policy goals, and it wastes agencies' resources without producing accurate or useful results. At a minimum, the SEC should, in explaining its statutory duty under Sections 3(f) and 23(a)(2), 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 Sections 3(f) and 23(a)(2)'s requirements. In addition, as mentioned above, there is no need for the agency to quantify or "determine" the Rules costs and benefits.

Moreover, in the Economic Analysis section of the Release, the SEC discusses specific costs and benefits associated with the Proposed Rule. Assuming that particular costs and benefits are at all relevant to the SEC's required economic analysis, the agency should more clearly set forth how those costs and benefits are directly related to protecting investors or to efficiency, competition, or capital formation.

2. The SEC should more fully set forth the connection between the particular proposed rule and the comprehensive, integrated framework of which it is a part.

The context in which the Proposed Rule is being promulgated, concurrently with a comprehensive overhaul of the entire security-based swap market under the Dodd-Frank Act, is extremely important and should have been more fully set forth in connection with the consideration of the application of Sections 3(f) and 23(a)(2). The agency appropriately acknowledges the Dodd-Frank Act authority for the Proposed Rule in the beginning of the Release and references various provisions that would correct problems that occurred during the last crisis. [36] However, it should more explicitly and

34 Release at 70,300.

35 *See, e.g.,* Release at 70,315 (discussing the effects of the financial responsibility requirements).

36 *See, e.g.,* Release at 70,258.

completely set forth the fact that the Rule was being proposed and promulgated as part of an entire framework under the Dodd-Frank Act, with the goal of protecting investors and promoting the public interest by preventing another crisis.

This level of explanation is appropriate to illustrate the larger interests at stake: not only protecting customer funds through segregation requirements, but increasing confidence in the markets, reducing the risk of failure among market participants that can spread throughout a market, and ultimately reducing the likelihood of a future financial collapse and economic crisis.

CONCLUSION

We hope these comments are helpful.

Sincerely,

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