Please note that the comments expressed herein are solely my personal views

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- 17 CFR Part 240
- File No. S7-25-11
- Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants

Dear Sir.

Thank you for giving us the opportunity to comment on your Proposed Rule: Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants.

You are proposing for comment new rules under the Securities Exchange Act of 1934 (Exchange Act) that are intended to implement provisions of Title VII (Title VII) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) relating to external business conduct standards for security-based swap dealers (SBS Dealers) and major security-based swap participants (Major SBS Participants).

I generally support the proposed rules. They are quite principles based, which is very often necessary when dealing with things like communication, disclosure, suitability and sales practices in rapidly evolving markets. The proposed rules will also increase transparency and reduce conflicts of interest, which will act to promote confidence in and the integrity of security-based swap markets. However, I would first comment that the proposed rules should ideally be as close as possible to the business conduct standards proposed by the Commodity Futures Trading Commission (CFTC) for swap dealers and major swap participants.[1] I would suggest that there is little administrative or economic rationale for proposing very different rules, and rule differences lead to duplication of reporting regimes at the lowest level of the

[1] See in particular CFTC proposed rules: Business Conduct Standards for Swap Dealers and Major Swap Participants With Counterparties, 75 FR 80638, RIN 3038-AD25, 22 December 2010.

reporting entities, which is counterproductive, confusing and wasteful. I would therefore recommend that the SEC and the CFTC should work even more closely together to propose one set of robust rules regarding (security-based) swap dealers and major (security-based) swap participants. This will reduce cost and complexity, and is in itself a strong signal to the markets that regulators are seen to be working more closely together, rather than within their individual silos. In this vein I would like to answer your following specific questions, before giving further comments:[2]

- Should the Commission require SBS Entities to perform periodic portfolio reconciliations in which they exchange terms and valuations of each security-based swap with their counterparty and also resolve any discrepancies within a specified period of time? If so, how frequently should portfolio reconciliations be performed and within what time period should all discrepancies be resolved? Should any specific policies and procedures be proposed regarding the method of performing a portfolio reconciliation? Should the Commission require any specific policies and procedures regarding the method of valuing security-based swaps for purposes of performing a portfolio reconciliation? Please explain the current market practice among dealers for performing portfolio reconciliations.
- Should the Commission require SBS Entities to periodically perform portfolio compressions in which the SBS Entity wholly or partially terminates some or all of its security-based swaps outstanding with a counterparty and replaces those security-based swaps with a smaller number of security-based swaps whose combined notional value is less than the combined notional value of the original security-based swaps included in the exercise? If not, why not? Should the Commission require SBS Entities to periodically perform portfolio compressions among multiple counterparties? If not, why not? Please explain the current market practice among dealers for performing portfolio compressions.

Answer – yes. Such rulemakings and practices should increase transparency, promote market integrity and reduce risk by:

- establishing procedures that will promote legal certainty concerning security-based swap transactions
- assisting with the early resolution of valuation disputes
- promoting and effecting the timely and accurate netting and valuation of security-based swaps
- reducing operational risk
- increasing operational efficiency.

I particularly support portfolio reconciliation requirements, which require SBS Dealers and Major SBS Participants (together, SBS Entities) to carry out portfolio reconciliation for their security-based swaps. I support that such reconciliation could be performed on a bilateral basis or by a qualified third party. I also support the principle that the frequency of reconciliation is tailored to the materiality and size of the security-based swap portfolio. In addition I support portfolio compression requirements, which would require the timely and accurate processing and netting of security-based swaps by SBS Entities. Portfolio

[2] See section III.B., pages 169-170 of the Proposed Rule.

compression is an important risk management tool that also helps to reduce costs, provide more efficient pricing and improve capital liquidity. Finally, such a rulemaking would improve regulatory consistency across swap markets.[3]

Material risks and characteristics of the security-based swap

I strongly agree that an SBS Entity should disclose information about the material risks and characteristics of the security-based swap, if there is a "substantial likelihood that a reasonable investor would consider the information to be important in making an investment decision".[4] It is entirely reasonable that SBS Entity's manage investors' expectations in this regard.

In answer to your specific question, the Commission should specifically require scenario analysis disclosure for "high-risk complex security-based swaps", as described in the CRMPG III report. The determination of a security-based swap as high risk and complex is a subjective exercise, and I would ask for further clarification, or a definition. I would further recommend that the Commission should create some central guidance, or rules, which would mandate a more consistent and robust stress testing here. For example, the stress scenarios could be calibrated to a 99,5% confidence level (tail event) over one year (commonly called a 1-in-200 year stress / event), or something similar, otherwise the scenario analysis may not provide meaningful information to counterparties.[5]

An SBS Entity should not have to provide scenario analysis disclosure for uncleared security-based swaps, unless they are "high-risk complex security-based swaps", as above. However, I would suggest that SBS Entity's should always disclose the additional risks created by uncleared security-based swaps. I.e. the additional risk present in an uncleared security-based swap compared with an identical cleared security-based swap.

Conflicts of interest

A conflict of interest arises when an SBS Entity's obligation to act in the best interest of its counterparty conflicts with any of

- the SBS Entity's own interest
- an interest of a connected party
- the interests of other third parties including other counterparties

Effective rules on conflicts of interest must include a general principle requiring SBS Entities to ensure that their ability to provide objective services (including advice) is not, and cannot be perceived to be, compromised. This would include advising not to enter into a transaction, if

[3] Consistency with the CFTC. See CFTC notice of proposed rulemaking: Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519, RIN 3038-AC96, 28 December 2010.

[4] See section II.C.2.c., page 46 of the Proposed Rule.

[5] Proposed §240.15Fh-3(b)(1) requires specific disclosure of "the factors or events that might lead to significant losses, the sensitivities of the security-based swap to those factors and conditions, and the approximate magnitude of the gains or losses the security-based swap will experience under specified circumstances". I suggest that robust stress testing and scenario analysis would provide accurate quantification here.

appropriate. I therefore strongly support proposed § 240.15Fh-3(b)(2) concerning material incentives or conflicts of interest. I strongly agree that it is the SBS Entity's responsibility to ensure that it is aware of any existing or potential conflicts of interest, and that these are disclosed up-front and documented, or else the SBS Entity should disqualify itself from acting in the particular case.

Daily mark

I agree broadly that an SBS Entity should disclose the daily mark to the counterparty. I agree that this would enhance transparency to counterparties during the lifecycle of a security-based swap.

Proposed §240.15Fh-3(c) concerning the daily mark states that for an uncleared security-based swap: "The security-based swap dealer or major security-based swap participant shall also disclose its data sources and a description of the methodology and assumptions used to prepare the daily mark, and promptly disclose any material changes to such data sources, methodology and assumptions during the term of the security-based swap". Given that the proposed rules do not prescribe a particular calculation methodology, the data sources, methodology and assumptions used to prepare the daily mark should be required to constitute a "complete and independently verifiable methodology for valuing each (security-based) swap entered into between the parties".[6] This would promote more objectivity and transparency in the process. Such proposals will also improve operational efficiency and may assist in the early and objective resolution of any security-based swap pricing or other valuation disputes.

Recommendation by SBS Dealers

Proposed § 240.15.Fh-3(f) requires that an SBS Dealer that recommends a security-based swap or trading strategy involving a security-based swap to a counterparty, other than an SBS Entity or Swap Entity, must have a reasonable basis to believe that: 1) the security-based swap is suitable for at least some counterparties; and 2) the security-based swap is suitable for the counterparty. I note that this requirement for a "duty of care" is not required by Dodd-Frank, but I accept your arguments, for consistency with other entities, in its favour. To efficiently facilitate this rule, and reduce any unnecessary burden on SBS Dealers, I would recommend that any suitability analysis should be required at the least granular level, e.g. on a transaction-by-transaction basis, on an asset-class-by-asset-class basis, or in terms of all potential transactions between the parties, as appropriate.

Anti-fraud provisions

I would generally support anti-fraud provisions that would act against and prevent fraudulent, deceptive or manipulative behaviour. However, security-based swaps are already subject to the general anti-fraud and anti-manipulation provisions of existing federal securities laws. The

[6] This wording is taken from the CFTC's Notice of proposed rulemaking: Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 76 FR 6715, RIN 3038-AC96, 8 February 2011. The quote is at 76 FR 6719.

SEC is also strengthening these provisions in its 3 November 2010 proposed rule.[7] I cannot see the need to duplicate these provisions here and so I would recommend that the SEC remove proposed § 240.15Fh-4(a).

Chief compliance officer

Proposed § 240.15Fk-1 concerns the chief compliance officer (CCO) role. I fully support the intent of the proposed rules here. The CCO role is the single most important compliance role in an SBS Entity and it is critical that its job description, the rules and the SBS Entity's structures and procedures, act to secure and maintain the CCO's independence. For example the CCO should have single compliance role and no other role or responsibility that could create conflicts of interest or threaten its independence, and the remuneration of the CCO must be designed in a way that avoids conflicts of interest with its compliance role.

Given the pressures that bear on the CCO with regard to managing conflicts of interest and maintaining independence, I would strongly recommend one specific change to the proposed rules. I would recommend that you amend the wording under proposed § 240.15Fk-1(d) such that the authority and sole responsibility to appoint or remove the CCO, or to materially change its duties and responsibilities, only vests with the independent directors and not the full board. This would help to ensure the independence of the CCO within the SBS Entity, and would mitigate the need for you to promulgate additional measures that could be required to adequately protect CCOs from undue influence or coercion in the performance of their duties.

Yours faithfully

Chris Barnard

[7] See SEC proposed rule: Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps, File No. S7-32-10, RIN 3235-AK77.