January 24, 2011

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

Re: Proposed Rules Governing Security-Based Swap Data Repository, Registration, Duties, and Core Principles – File Number S7-53-10

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules ("Proposed Rules") of the Securities and Exchange Commission ("Commission"). The Proposed Rules establish requirements for Swaps Data Repositories ("SDR") relating to: (1) registration with the Commission; (2) collection and maintenance of data on security-based swaps ("SBS"); and (3) compliance with core principles on corporate governance and conflicts of interest. The Commission has issued the Proposed Rules in accordance with Section 763(i) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

Introduction and Summary of Comments

The statutory role and importance of the SDR cannot be overstated. It is unique and critical to the proper functioning of the market structure envisioned by the Dodd-Frank Act. Because the Dodd-Frank Act mandates the use of an SDR by market participants, the regulatory implementation must address potential abuses by SDRs, which could hold a market captive and defeat the purposes of reform.

[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.

Independence of the SDRs from the influences of market participants is essential to the effectiveness of the reforms of the Dodd-Frank Act, but competition to ensure efficient pricing and quality of the services provided by an independent SDR may not emerge because of the very nature of its function. Moreover, achieving the underlying goal of price transparency and discovery requires a system of data dissemination that is practically useful to individuals who trade in the markets and there is no assurance that such a system will emerge without express guidance in the implementing of regulations.

Unfortunately, the unique role of SDRs results in conflicting and complex forces and incentives. In particular, their position in controlling data flow raises the threat that they will provide some market participants with different categories of data at different times. SDRs must not be permitted to facilitate this practice. A central goal of the Commission, consistent with the fair and transparent markets mandated by the Dodd-Frank Act, is that market information must be made available in meaningful form on an equal basis, in terms of time of availability and content, to all market participants.

We recognize that a less proscriptive regulatory approach, which might allow for solutions to emerge based on broad goals, might yield an effective result. However, the circumstances here ***require*** a proactive approach to the regulations implementing the SDR provisions of the Dodd-Frank Act.

The Proposed Rules include many reasonable and effective standards governing the registration process for SDRs and the duty of SDRs to collect and safely store SBS data. However, the Proposed Rules do not focus adequately on the basic purpose for the SDR requirement: that traders, the public, and the regulatory community have fair and equal access to comprehensive SBS transaction data in a meaningful format.

Therefore, the rules must include comprehensive and uniform data aggregation, formatting, and dissemination requirements. Moreover, the Proposed Rules must impose more effective corporate governance standards upon SDRs, including independent board member requirements, ownership and voting restrictions, and measures that will promote a more meaningful role for Chief Compliance Officers. Finally, the Proposed Rules must establish additional requirements to ensure that access to data is provided at both a reasonable price and without favoritism, untainted by the discriminatory and anti-competitive pricing arrangements that have for so long characterized these financial markets.

Focus on the Underlying Purpose for SDRs: Effective Data Dissemination

The Proposed Rules are intended to implement the specific duties imposed upon SDRs by Section 763(i) of the Dodd-Frank Act. Those duties encompass all facets of data compilation and dissemination. Although the Proposed Rules include reasonable requirements relating to data collection and storage, they do ***nothing*** to ensure that the data amassed by individual SDRs is aggregated and disseminated in a form that is

genuinely useful to traders and regulators and on a nondiscriminatory basis.

Establishment of a meaningful data distribution system is a vital prerequisite to real transparency in the SBS market. The collection of data is, by itself, not meaningful; it is essential that the data can ultimately be put to use by market participants.

Here are some general principles that must be used to construct a system of useful market information:

- ***All information must be made available to the market participants and the public on an equal basis.*** This means:

  (1) the data content must be uniform, with no privileged access to information such as order cancellations and the source of bids and offers;

  (2) there should be no advantage provided in terms of time of availability. Direct feeds from SDRs (or from exchanges or SEFs) to certain privileged market participants which bypass the aggregation and general dissemination process serve only to harm transparency and create information asymmetries that reduce efficiency in the marketplace.

  In brief, the entity or entities responsible for disseminating the data must not be permitted to offer advantageous data access to any market participants whether or not such advantage is granted based on compensation or on direct or indirect relationships.

- ***Transactions that are apparently complex must be broken down into meaningful components.*** Many transactions and transaction types that have been characterized as too complex for reporting or dissemination are in fact only composites of more straightforward transactions. Any reporting regime must address this issue. The regime ***must require disclosure of information on these components*** to provide meaningful transparency and prevent market participants from avoiding disclosure by creating composite transactions that are hard to understand.

- ***Transactions must be aggregated through price relationships.*** Market participants already recognize these relationships in their daily activities, often hedging a position with a price-related class of derivative. These ***"hedge equivalent"*** transactions are an important feature of a market in which liquidity varies dramatically—less liquid contracts are hedged, often imperfectly, with price-related, more liquid contracts. The dissemination of data must be in a format that reflects this.

The first principle is central to a marketplace that is fair and transparent (different levels of access are inherently unfair and are not meaningfully transparent). The other two principles represent the language of market participants and the dissemination of market information must be expressed in this language.

The gaps in the regulatory scheme were apparent in the Commission's recently proposed "Regulation SBSR," which also dealt with the collection and handling of SBS transaction data.[2] As observed in that context, creating a properly formatted and aggregated stream of SBS data is essential:

> To achieve price discovery in any meaningful sense of the term, the data must be disseminated by delivery to market participants in a format that individual traders will actually use in their daily activities. For this to occur, the data must be made available to traders in a format which they understand and in a mode that:
>
> - allows them to view it in near-real time;
> - fits onto the limited space on their trading screens; and
> - allows multiple markets to be viewed simultaneously, including security based and non-security based swap markets that are related.[3]

As also observed, the Commission must establish a system that "will provide all market participants, members of the public, and regulators with a central source for SBS data collected by all SDRs."[4] Those observations calling for more effective regulation apply with equal force to these Proposed Rules.

The third point listed above must be underscored. The derivatives markets are characterized by their fragmented nature. There are multiple asset classes that are unique but also involve various pricing relationships. In this regard, the Commodity Futures Trading Commission's ("CFTC") recognition of hedge equivalent contracts in its analysis of positions and position limits is instructive and illuminating. The system for dissemination of market data arising out of these Proposed Rules must not create artificial separation of data; it must be responsive to the market reality that different asset classes are, in fact, related, as the CFTC recognized.[5]

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[2] *See* Regulation SBSR – Reporting and Dissemination of Security-Based Swap Information, 75 Fed. Reg. 75208 (Nov. 19, 2010).

[3] Letter from Better Markets, Inc. to the Securities and Exchange Commission on Proposed Regulation SBSR, File Number S7-34-10 (submitted Jan. 18, 2011).

[4] Better Markets Comment Letter, *supra* note 3, at 3.

[5] *See* Notice of Proposed Rulemaking, Commodity Futures Trading Commission, "Position Limits for Derivatives," RIN 3038-AD15 and 3038-AD16 (Jan. 13, 2011).

These shortcomings in the Commission's approach are especially troubling since the Dodd-Frank Act clearly authorizes the Commission to implement a comprehensive data distribution system, and since the Commission seems to appreciate the value of such a system—if not the urgent need for it.

As to legal authority, the Dodd-Frank Act gives the Commission ample authority to require public dissemination of SBS data in "such form and at such times as the Commission determines appropriate to enhance price discovery." Section 763(i). The statute also requires each SDR to "provide [SBS data] in such form and at such frequency as the Commission may require to comply with the public reporting requirements . . . ." *Id.*

As to the Commission's understanding of the importance of SBS transaction data, the Release canvasses the many reasons why SBS data ***must*** *b*e available to the public and to regulators: to monitor risk concentration in the market, to enable regulators to prevent fraud and manipulation, and, of course, to enhance price transparency for the benefit of those who seek to enter SBS transactions fairly and efficiently. Release at 77307.

In the Release, the Commission also repeatedly signals its awareness of these important goals and the need to impose aggregation requirements to achieve them. For example, the Commission observes that SDRs can help avoid a market in which "SBS transaction data is dispersed and not readily available to regulators and others." *Id.* In addition, through its specific requests for comment, the Commission indicates that it is actually contemplating data aggregation and formatting requirements, at least for regulatory and data-storage purposes:

- "[s]hould the Commission designate one SDR as the recipient of the information of other SDRs, through direct electronic access to the SBS data at the other SDRs, in order to provide the Commission and relevant authorities with a consolidated location for SBS data?" Release at 77309.

- "Should the Commission require that all SDRs maintain [stored SBS data] in the same format?" *Id.* at 77331.

- "Should the Commission require that SDRs establish and maintain effective interoperability and interconnectivity with other SDRs, market structures, and venues?" *Id.*

- "Should the Commission specifically require the SDR to organize and index accurately the transaction data and positions so that the Commission and other users of such information are easily able to obtain the specific information that they require?" *Id.*

Regrettably, the Commission also explains that on these and related data management issues, it is adopting a wait and see approach and is deferring any action to institute a more elaborate and effective data distribution system. For example, in explaining its decision not to propose rules on systems for monitoring, screening, and analyzing SBS data, the Commission offers this rationale: "The market infrastructure of the SBS market is in its infancy.... As [it] continues to develop and the Commission gains experience in regulating this market, the Commission will consider further steps to implement this statutory provision." Release at 77318.

That is the entirely wrong approach. The fact that this market is in its "infancy" is a unique opportunity for the Commission to guide its development in a way that protects the public interest, promotes competition, and prevents what has been the routine development of conflicts and predatory conduct.

The swaps markets are enormous and sophisticated. They are also very dangerous because they can multiply the risks inherent in the underlying markets by many times, as made painfully clear in the fall of 2008. It is true that the market structures required by the Dodd-Frank Act are unprecedented and complex. But the Commission must confront head-on the challenge of implementing this structure with rules that truly fulfill the purposes embodied in the Dodd-Frank Act: a fair, efficient, and above all transparent marketplace.

This is particularly obvious when considering the question of interoperability and interconnectivity. This issue concerns the relationships between derivatives markets based on hedge equivalent and other price relationships. Financial institutions already recognize these relationships and their data systems track them so that their traders can view the markets in different combinations. The SDR system must be interconnected if it is to reflect the markets in a way that is useful to those traders.

It should be noted that the Consolidated Tape Association (CTA) system currently in place for U.S. equity markets demonstrates that the system proposed is feasible. Under the CTA system, individual exchanges send transaction data directly to a central aggregator that consolidates and then distributes the data to market participants. There is no obvious reason why a similar regime could not succeed for SBS.

On the other hand, it is essential that the data dissemination regime for SBS avoid the dangerous trend of direct data feeds from exchanges to privileged market participants that has become prevalent in U.S. equity markets. This proliferation of direct data feeds has created a system that allows high-frequency traders to bypass the aggregation and dissemination procedure, at the expense of retail and other investors. Such an outcome in the SBS markets would clearly be counter to the principles of the Dodd-Frank Act described herein.

Thus, the SDR system must be even-handed with respect to the categories of information and the time of their availability. The "real time" standard set forth in the Dodd-Frank Act

must not be used as a mechanism for creating a class of market participants that have an embedded advantage because they are able to acquire privileged access to information flows.

The Commission must adopt a much more proactive approach to the all-important challenges surrounding the dissemination of SBS transaction data. All of the questions set forth above must be answered in the affirmative, and the Commission must pursue these and any other steps that are necessary to give the public, as well as regulators, access to complete, usable, real-time SBS transaction data on an equal basis.

Meaningful Requirements for Corporate Governance, Conflicts of Interest, and Fair Access

Conflicts of interest have been, and continue to be, pervasive in the derivatives trading business. In our comment letter previously submitted to the Commission on November 26, 2010, regarding ownership and governance requirements for various SBS entities, we reviewed the history and causes of those conflicts of interest.[6] No one can deny that, *for many years, the derivatives industry has been marked by formal and informal influences that favor certain market participants over others, ultimately to the detriment of the public.* Those influences range from weak corporate governance structures to preferential fee and revenue arrangements.

If the rules addressing conflicts of interest are not sufficiently robust and do not effectively limit the many direct and indirect methods of exerting influence, a marketplace characterized by anti-competitive practices will continue. The transparent, competitive, fair, and risk-reducing marketplace envisioned by the Dodd-Frank Act will never be realized. Worse yet, excessive risk-taking will actually be encouraged as the few participants that benefit from these arrangements maximize profits in markets structured to favor them.

The dangers presented by conflicts of interest are especially serious given an SDR's role in collecting and disseminating SBS data, which includes information about the parties, pricing, positions, and terms of SBS transactions. Control over information confers

[6] See Letter from Better Markets, Inc. to the Securities and Exchange Commission, "Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies," File Number S7-27-10 (submitted Nov. 26, 2010). We have submitted numerous other letters on the subject of conflicts of interest, reflecting the importance of the issue. *See* Letter from Better Markets, Inc. to the Commodity Futures Trading Commission, "Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding Mitigation of Conflicts of Interest," CFTC RIN 3038-AD01 (submitted Nov. 17, 2010); Letter from Better Markets, Inc. to the Commodity Futures Trading Commission, "Implementation of Conflicts of Interest Policies and Procedures by Futures Commission Merchants and Introducing Brokers," CFTC RIN 3038AC96 (submitted Jan. 18, 2011). In addition, today we are filing a comment letter with the Commodity Futures Trading Commission on "Implementation of Conflicts of Interest Policies and Procedures by Swap Dealers and Major Swap Participants," CFTC RIN 3038-AC96.

extremely powerful economic advantages over other market participants, with commensurately powerful temptations for abuse.

The Release correctly highlights a number of the harmful practices that can thrive in an environment that does not adequately address conflicts of interest: limiting access to information to gain competitive advantage, favoring certain market participants over others with respect to services and pricing, requiring the purchase of services on a "bundled" basis to maximize profit, and misappropriating confidential or other information provided to an SDR. Release at 77324-25. The Proposed Rules must be strengthened to address these dangers more effectively.

We recognize that issues of governance and conflicts of interest must be addressed in the context of developments since the onset of the financial crisis. In particular, as part of the self-initiated restructuring of the credit default swap market, a data warehouse function was provided by the Depository Trust Clearing Corporation ("DTCC"). This may well have improved the structure of that marketplace. However, it is extremely difficult to see how the ownership, board structure, and history of DTCC is consistent with the independence from conflicted influences that must be required by implementing regulations. These circumstances must not deter the Commission from reaching the correct result.

Indeed, these circumstances demonstrate that doing nothing would be a serious error. There is simply no basis for regulators to rely on marketplace participants to produce a system that is consistent with the critically important statutory requirements. In fact, if left to their own devices, those market participants will fashion a market that maximizes their own profits and embeds anti-competitive practices.

Corporate Governance

The corporate governance standards for SDRs set forth in the Proposed Rules are exceedingly general, requiring only that corporate governance arrangements be clear, provide "fair representation of market participants," and ensure levels of competence among members of the board and senior management. Proposed Rule 240.13n-3(c)(2). The rules must be much more detailed and clear. Most importantly, they should require SDRs to establish boards and nominating committees that are composed of a majority of independent directors. Independent boards are one of the most effective tools for ensuring that an SDR will abide by the letter and spirit of the enumerated duties and core principles set forth in the Dodd-Frank Act.

Equally important are restrictions on ownership and voting interests in an SDR. The Proposed Rules do not include any such standards, which are important safeguards against the dominant influence of some market participants over others. The rules should impose both individual and aggregate limits on ownership and voting. For example, the rules should limit the aggregate ownership interest in an SDR by SDR participants and their related persons to 20%. Similarly, the rules should prevent SDR participants and their

related persons from directly or indirectly exercising more than 20% of the voting power of any class of ownership interest in the SDR.

Chief Compliance Officer

Another essential component of an effective corporate governance structure is a Chief Compliance Officer ("CCO") who is insulated from the incentives and pressures that corrupt or erode independent judgment. The Proposed Rules provide for a number of commendable safeguards, but they must be fortified if they are to work in the reality of the marketplace. *See generally* Proposed Rule 240.13n-11.

The Proposed Rules impose no limitations on the type of corporate officer who may serve as the CCO. At a minimum, the rules should preclude the General Counsel or a member of that office from serving as CCO, since those attorneys owe a duty of loyalty to the SDR itself that may not be compatible with the watchdog function of the CCO. With respect to compensation and termination of the CCO, the Proposed Rules appropriately assign authority over those matters to the board, rather than management. The rules should go one step further and confer that authority upon the *independent* board members.

In addition, the CCO should have a direct reporting line to the independent board members and should be required to meet with those independent members at least quarterly. This will provide the foundation for the independent members of the board to become effective partners with the CCO in promoting a culture of compliance within the SDR.

Under the Proposed Rules, the CCO must prepare an annual compliance report and submit it to the board and to the Commission. Proposed Rule 240.13n-11(d). Two enhancements to these provisions are necessary. First, the review and reporting should be more frequent, at least semiannually or quarterly. Second, the rules should expressly prohibit the board of an SDR from requiring the CCO to make any changes to the compliance reports. Any edits or supplements to the report sought by the board may be submitted to the Commission along with—but not as part of—the CCO's report.

Finally, as suggested in the Release, the rules "should prohibit any officers, directors, or employees of an SDR from, directly or indirectly, taking any action to coerce, manipulate, mislead, or fraudulently influence the SDR's CCO in the performance of his responsibilities." Release at 77341. A strong deterrent against attempts to mislead or coerce the CCO is an extremely important element of any corporate governance structure that hopes to protect the CCO's independence.

Fair Access

The Proposed Rules must establish stronger and more detailed standards against discriminatory access, and they should also establish regulatory oversight of access denials. The Release correctly identifies the threat of anticompetitive behavior that the rules must

address: "The Commission is concerned, among other things, that an SDR, controlled or influenced by a market participant, may limit the level of access to services offered or data maintained by the SDR as a means to impede competition from other market participants or third party services providers." Release at 77321.

However, the Proposed Rules do not adequately neutralize this threat. They provide that access to services offered and data maintained must not be "unreasonably discriminatory," but they do not flesh out this vague standard. Proposed Rule 240.13n-3(c)(1). Instead, the rules leave it to the SDRs to establish "clearly stated objective criteria" that will ensure fair access. Those criteria must be set forth in the rule itself, and they should include a provision that permits denial of access only on risk-based grounds *i.e.* risks related to the security or functioning of the market. To do otherwise only invites ambiguity and abuse.

In addition, the rules should institute a regulatory oversight mechanism that will help ensure compliance with fair access standards. The Proposed Rules require SDRs to conduct an internal review of any prohibition or limitation on any person's access to an SDR's services or data. Proposed Rule 240.13n-3(1)(iv). This is useful but not sufficient. As suggested in the Release, the rules should also require an SDR "to promptly file a notice with the Commission if the SDR . . . prohibits or limits any person's access to services offered or data maintained by the SDR." Release at 77322.

Fair Pricing

The Proposed Rules are similarly lax with respect to anti-competitive pricing. As explained previously, preferential and discriminatory pricing arrangements have been used historically by some derivatives market participants to establish and maintain highly profitable positions of dominance. To address this deeply rooted, anti-competitive practice, the Proposed Rules rely on overly general standards of conduct: a prohibition against "unreasonably discriminatory" fees, a requirement that fees be "fair and reasonable," and a requirement that fees must be "applied consistently across all similarly-situated users" of the SDR's services. Proposed Rule 240.13n-3(c)(1)(i).

Frankly, these vague phrases are no standards at all. Again, they invite self-serving interpretations and application, which are predictable given the vast amount of money involved. The Release acknowledges as much by observing that "[t]he terms 'fair' and 'reasonable' often need standards to guide their application in practice." Release at 77320. Yet the Commission declines to establish fees, rates, or even formulas for determining rates, choosing instead—and without any justification—to adopt a "flexible" approach and to evaluate charges on a "case-by-case basis." This approach will do little to change business as usual in the realm of preferential pricing, predatory conduct, and embedded conflicts.

Unavoidably, single-source SDRs may emerge in given markets. The function of the SDR suggests this potential outcome. As a result, implementing regulations must anticipate and

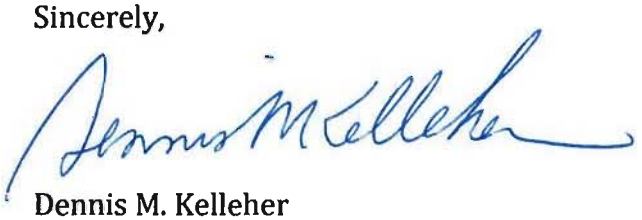
prevent this eventuality. A more proactive approach to standards for the quality of data dissemination, as outlined above, addresses this issue from a functional standpoint.

But pricing is also a major concern in a market where participants are legally bound to use the service of an SDR. We propose that, in SBS markets where there is no effective competition, SDRs must be required to justify the reasonableness of price levels charged to both suppliers of data and recipients of data. The Commission must not allow a system that empowers monopoly SDRs to take unfair advantage of the mandated use of their services.

Conclusion

It is vitally important that the Commission establish clear and strong standards governing the conduct of SDRs as they handle large volumes of data, provide access to users, and manage conflicts of interest. We commend the SEC for its Proposed Rules in these areas, and we hope that our comments will assist the Commission as it finalizes its regulations.

Sincerely,



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