November 3, 2011

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Chairman Gensler:

We understand that the Commission is close to finalizing its external business conduct rules and that the final rules are likely to incorporate significant revisions. As you know, our organizations were strong supporters of the CFTC's original rule proposal. We want to make sure you are also aware of our strong opposition to the companion SEC rule proposal, which eviscerates the rules' protections for special entities. The purpose of this letter is to urge you, as you move toward finalization of the business conduct rules, to ensure that the important protections provided under the CFTC's original proposed approach are not lost in an effort to accommodate sometimes legitimate, but often exaggerated concerns that have been raised with regard to the rules.

Toward that end, we have engaged in lengthy discussions in recent weeks with members of the staff involved in working on these rule proposals. Staff members have been both extremely generous with their time and attentive to our concerns. Moreover, while we may not always reach the same conclusions about the best approach, it has been clear from those discussions that they are sincerely motivated to come up with an approach that is both workable and effective. Recognizing that some revisions to the rule are inevitable, our goal has been to identify approaches that respond to criticisms that industry interests have raised particularly insistently without unacceptably weakening the rules, particularly with regard to protections provided for those most vulnerable of swap market participants, special entities. That is the goal of this letter as well.

We would also note the special role that the CFTC plays in relation to the concerns that led Congress to include explicit business conduct standards in the Dodd-Frank Act. To a significant degree, these rules were enacted as a response to revelations about the exploitation of relatively unsophisticated municipal customers in the interest rate swaps markets overseen by the CFTC. Because interest rate swaps are so commonly used to hedge risks in connection with borrowing, they are the swaps most frequently used by even unsophisticated borrowers. Standardization has also advanced further in the interest rate swaps market than in other types of

swaps, so customers have greater alternatives to the complex customized instruments that are most likely to trigger the strongest kinds of duties related to business conduct standards. These considerations make it especially important for the CFTC to enact strong and durable protections.

The following discussion focuses on a few key interrelated aspects of the rule proposal that are central to its effectiveness: the definition of acting as an adviser, the requirements for independent representatives of special entities, the requirements for reasonable reliance on representations, disclosure obligations, the suitability standard, and the applicability to major swaps participants. Unless these provisions retain their integrity, the business conduct rules will not deliver the enhanced protections for special entities intended by Congress and needed to address pervasive abuses.

1) The definition of acting as an adviser

The original CFTC rule proposal included a definition that equated acting as an adviser with making a recommendation. Industry argued, with some justification, that they needed greater clarity regarding precisely what conduct would and would not constitute acting as an adviser so that they could be certain when they were subject to the best interest standard. The SEC proposal provides that certainty, but it does so in a way that, in practice, is likely to prevent the best interest standard from ever actually applying to protect special entities. The SEC proposal provides that the swap dealer may require customers to waive any protections from the best interest standard through a simple written representation early in the transaction. With this representation in hand, the dealer could provide extensive customized advice and recommendations without any requirement to respect client best interests. If the SEC approach were adopted, these opt-outs would quickly become a condition of doing business, and the intent of Congress to provide enhanced protections for special entities would be thwarted.

There is a middle ground that would provide the greater certainty that industry has demanded without inappropriately undermining protections for special entities. To begin with, the Commission could, and probably should, tighten the definition of acting as an adviser to clearly exclude any recommendation that isn't particularized for the special entity. Toward that end, we have recommended using as a model the language SIFMA has suggested in other discussions (of retail fiduciary duty) as a definition of personalized investment advice. Adapted to the swaps market, the definition would be: "recommendations related to a swap or a swap trading strategy that are made to meet the objectives or needs of a specific counterparty after taking into account the counterparty's specific circumstances."

This revised definition – which clearly excludes any more generic recommendations or general information – could then be supplemented with more detailed guidance on what conduct falls within and what conduct falls outside the definition. The original CFTC proposal begins this process by excluding from the definition the provision of general transaction, financial or market information to the special entity and the provision of swap terms in response to a competitive bid request from the special entity. However, additional guidance is probably needed to distinguish between those communications that simply list available options and those that are designed to steer the special entity toward a particular product or strategy. To ensure

that the guidance is sufficiently detailed to respond to industry's need for certainty, the Commission could solicit input from market participants regarding the situations where they believe clarification is needed.

As long as the Commission adopts a definition that ensures that swaps dealers' personalized recommendations are subject to the best interest standard, it could supplement this standard with an approach that uses written representations as to the nature of the relationship. Importantly, the written representations would not supersede in circumstances in which the swaps dealer was engaged in conduct that would fall within the definition of advice. As such, they would simply clarify the nature of the relationship, not offer a safe harbor from the best interest standard in circumstances in which it would otherwise apply. Operating in conjunction with the seller's exemption that has been proposed under the Department of Labor's expanded fiduciary definition, this should make crystal clear that swaps dealers would not be subject to an ERISA fiduciary duty simply by virtue of compliance with the business conduct rules. Thus, their ability to act as counterparties to ERISA pension funds would be unimpeded.

As a final comment in this area, we would note that the costs and benefits of best interest standards appear to have been distorted in the discussion of this rulemaking. There is some legitimacy to industry contentions that there should be more clarity in the definition of 'advice' that triggers a best interest standard. However, there has been significant exaggeration of the potential risk to the market that would be created by the mere possibility of a best interest standard applying in cases of customized advice. A clear bright line already exists in the case of all exchange-traded swaps, as well as arms-length transactions for completely standardized swaps. As mentioned above, standardized swaps markets are particularly well developed and deep in the case of interest rate swaps. In addition, there is ample space to define the provision of unbiased information or details to the counterparty which differs from advice or recommendations. Finally, even in cases where the best interest standard applies, the hedging function of swaps means that risk-reducing transactions can benefit both parties in a trade ex ante (much as insurance transactions do).

2) The requirements for independent representatives of special entities

a. Independence

Another way the Act seeks to protect special entities is by requiring that they have an independent representative – either an internal employee or an external adviser – with the requisite swaps market experience and expertise. Recognizing, however, that there is no way to guarantee independent representatives would have the financial sophistication to deal as equals with swaps dealers, Congress proposed this as a supplement to the swaps dealer best interest standard, rather than as a replacement for that standard. We believe this is the right approach, and one that is subverted by the SEC's proposal to allow swap dealers to opt out of their best interest obligations, even where they are giving advice, so long as the special entity certifies that it is relying on an independent representative for advice.

Having strong requirements for independent representatives is important in its own right. If, against our strong recommendation, you significantly weaken or narrow the application of the

best interest standard, it becomes all the more important to have the strongest possible rules in place regarding independent representative. Among the reasons we are so extremely concerned about the SEC's proposed rule for special entities is that it relies exclusively on the so-called independent representative to protect the special entity, then sets a standard that permits that representative to be deeply financially dependent on the swaps dealer on the other side of the transaction. The justification offered for this approach is that it enables certain market participants to serve this function (e.g., Blackrock) who have the sophistication we would look for in an independent representative, but with complex interactions with swaps dealers that might be viewed as compromising their independence.

The question the Commission must ask itself is whether crafting the rule to accommodate a few such entities justifies bending the rule on independence, and what sorts of unsavory practices would be permitted as a result. We do not think this makes sense as an approach. If, however, the Commission does decide that some sort of accommodation is called for, it must do far more than the SEC has proposed to do to address the potential abuses associated with that approach. Certain practices, such as trading at arm's length as a counterparty with the swap dealer in transactions unrelated to the one on which it is advising, may pose minimal conflicts that could be addressed through disclosure. Other practices, such as the receipt of referrals and referral fees, create clearly unacceptable conflicts and must be banned. In the middle, there is likely to be a vast gray area where additional safeguards would be required if the Commission, against our recommendation, chooses to allow such conflicts.

Obviously, to be truly independent, the independent representative shouldn't have any direct or indirect stake in the transaction for which it is serving as adviser, except in the form of compensation from the special entity. Moreover, such compensation should not be contingent on the outcome of the representative's recommendation. Compensating the independent representative only in cases where a swaps deal was completed would give the dealer inappropriate influence over independent representative compensation. In addition, the independent representative may add as much or more value for the customer in cases where they advise the customer not to use swaps as in those cases where they help structure a successful deal. While fiduciary duties can allow for conflicts in certain circumstances, even the less rigid Investment Adviser Act fiduciary standard sets limits on conflicts that are simply too extensive to be appropriately managed. We believe this constitutes just such a conflict.
.

In any instance where conflicts or side agreements are permitted and judgment is called for, the rules should require that conflicts be fully disclosed to the board of the special entity and that any such disclosures to the board be sufficiently detailed to allow the board to assess not just the existence, but also the magnitude, of the conflict. Moreover, conflicts should have to be appropriately managed to minimize the potential for abuse. On this issue, there can be no compromise. If conflicts are so extensive or complex that they cannot be clearly disclosed, then they also cannot be appropriately managed. In that case, protecting special entities from inappropriately conflicted advice from the supposedly independent representative must take precedence over permitting the widest array of market participants to serve as independent representatives.

b. Swaps dealer evaluation of the independent representative

In one of its more awkward provisions, the Act makes the swaps dealer responsible for ensuring the independence and competence of the special entity's independent representative. It is our understanding that this legislative language was originally proposed by members of the pension community, but it has since created a great deal of angst among certain members of the special entity community, particularly among pension plans. The CFTC includes a mechanism in its proposed rule designed to enable the agency to protect against misuse of this authority by swaps dealers. However, this has not gone far enough to allay some special entities' concerns. Some have proposed that a certification program be established that would include registration and testing. We believe this approach offers promise. But it is a longer-term solution and not within the control of the Commission. The business conduct rules cannot be put on hold while such a system is established.

We agree, however, that special entities would benefit from a system that leaves as little room as possible for subjective judgments on the part of swaps dealers about the qualifications or sophistication of the independent representative. Where special entities have appropriate procedures in place for selection of an independent representative, and where they can show that they have complied with those procedures, it may be appropriate to rely extensively on written representations to satisfy this requirement. (One exception would be instances in which the swaps dealer knows of a conflict that would violate the independence rules, in which case the dealer would be required to bring that conflict to the attention of the special entity and its board.) Among the factors that could be included in the conditions for relying on written representations is a requirement that the independent representative fall within some regulatory category (commodity trading advisor, investment adviser, ERISA fiduciary) subject to a fiduciary duty to the special entity. That way, the legal obligations of the independent representative to act in the best interests of the special entity would have some regulatory backing.

3) Reasonable reliance on representations

The issue of reasonable reliance on written representations is incorporated throughout the rule proposals. That makes it absolutely essential that the rules incorporate an appropriate standard for when it is reasonable to rely on such representations without further inquiry. The original CFTC rule proposal includes a standard for reliance without further inquiry that generally meets this test. Neither alternative suggested in the SEC rule proposal comes close to being adequate. One would allow reliance on written representations without further inquiry in any instance in which the swaps entity did not actually know the representations to be false. The other is only slightly better. It would allow reliance without further inquiry unless the swaps entity has information that would cause a reasonable person to question the accuracy of the representation. At best these proposed standards would encourage a see-no-evil approach to compliance; at worst they would promote a cynical disregard for the rules. Rather than weakening its original proposed standard, the Commission should strengthen it by adding an explicit requirement that the written representations be sufficiently detailed to allow regulators to determine whether the decision to rely on those representations is reasonable. That would allow for appropriate enforcement of a requirement that is integral to the rules' effectiveness.

4) Disclosure obligations

Like the requirements for independent representatives, disclosure rules are vitally important in their own right, and even more important if the best interest standard is narrowed or weakened. In either case, it is essential that disclosure requirements be sufficient to provide the independent representatives of special entities with all the information they need to fully and carefully evaluate proposed transactions. One issue that arises in this context is the format of the disclosures. The SEC has proposed that pre-transaction oral disclosures could satisfy this requirement, so long as they were supplemented by post-transaction written documentation. This is an open invitation to misunderstandings at best, and manipulation at worst. Moreover, the availability of electronic communication methods that offer the immediacy of oral communications but the verifiability of written disclosures makes this proposal completely unwarranted.

But heavy reliance on the independent representative also has implications for the content of those disclosures, particularly with regard to conflicts of interest, risks, and key characteristics of the transaction. It is crucial for disclosures to explicitly include information on prices and spreads and comparison between these prices and going fair value rates for similar swaps based on the swap curve. The lack of such information has led to massive and routine overcharging of "special entity" clients by swaps dealers. The respected fixed income derivatives expert Andrew Kalotay has analyzed interest rate swaps purchased in 2008 by the Denver Public Schools and found that the school system paid a spread that was between 100 and 200 times what he considered fair value.[1] He stated that this was "typical" of interest rate swaps contracts purchased by municipal entities. Risk disclosures should also require clear and comprehensible scenario analysis, and should be specifically required to clearly disclose key risk characteristics such as swap liquidity and the costs of unwinding the swap.

It is also vital to explicitly require swaps dealers that recommend customized swaps to show the standardized alternative, the price of that alternative, and to break out any price differential based on the specific elements of the customized swap. Such price information is routinely provided when a customer purchases an automobile with additional features, and there is no reason why it could not be provided for a swap. The dealer should also assess the relative risks of the two approaches.

Those suggested changes become all the more important if the scope of the best interest obligation is narrowed. Also, while the SEC and CFTC proposed rules include virtually identical language on disclosure of conflicts, they are accompanied by very different discussions of how those rules might be implemented. It is absolutely essential that conflict disclosures be designed to fully reveal the expected financial benefits of a proposed transaction relative to other options.

5) The suitability standard

The suitability standard provides an important supplement to the best interest requirement for special entities. The more conduct falls outside the best interest standard, the more important

[1] Prepared Statement of Andrew Kalotay, SEC Hearing on The State of the Municipal Securities Market, Birmingham, Alabama, July 29, 2011.

the suitability standard becomes. There must be no opt-out from the suitability standard, at least with regard to special entities, in cases where a recommendation is made. There is no benefit to be gained from allowing the recommendation of unsuitable transactions and strategies that could possibly justify providing an opt-out from a suitability standard. To the degree that greater clarification is needed about what does and does not constitute a recommendation, the Commission should seek to provide that clarification. The distinguishing characteristic of a recommendation should be some form of call to action. Simply providing information, on the other hand, would not constitute a recommendation. Under no circumstances should a swap dealer or major swap participant ever be permitted to recommend something that they don't have a reasonable basis for believing would be suitable for somebody in circumstances approximately those in which the recommendation is made. Finally, while it may be appropriate to allow reliance on written representations with regard to the facts on which a suitability analysis would be based, it would not be appropriate to allow reliance on written representations to substitute entirely for that suitability analysis.

6) Applicability to major swap participants

We are concerned that certain requirements are imposed based on regulatory status – swaps dealer vs. major swap participant – rather than on the function served. Basing regulatory standards on regulatory status, rather than on function, runs the risk of creating the problem we are struggling to correct in the securities markets, where brokers have been allowed to offer investment advice under a lower standard of conduct than applies to all other advisers. Limiting certain standards to swaps dealers only works if engaging in the conduct subject to that standard would automatically trigger a requirement to be registered as a swap dealer. It is not clear to us that this is always the case in these rules. A far better approach is to base the regulatory requirement on the function – such as acting as an adviser to a special entity – and apply it regardless of the regulatory capacity of the entity performing that function. That way, major swaps participants would be exempt as long as they don't engage in the activity that is subject to the regulatory requirement, but they would not be able to engage in the activity without triggering appropriate regulatory standards.

* * *

The provision of Dodd-Frank giving the SEC and CFTC broad new authority to set business conduct rules for swaps dealers and major swap participants was adopted in response to evidence of widespread abuses. Among the most devastating were abuses that targeted special entities, such as municipalities and school districts. In evaluating revisions to its proposed business conduct rules, Commissioners must weigh whether the revised rules are likely to be effective in combatting those abuses. Many of the revisions that have been proposed fail that test. In most if not all such cases, alternatives exist that would address legitimate concerns without unduly compromising appropriate protections. We urge you to seek out such solutions.

Thank you for your attention to our concerns.

Respectfully submitted,

Barbara Roper
Director of Investor Protection
Consumer Federation of America

Marcus Stanley
Policy Director
Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- A New Way Forward
- AARP
- AFL-CIO
- AFSCME
- Alliance For Justice
- Americans for Democratic Action, Inc
- American Income Life Insurance
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International

- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Trust
- National Housing Trust Community Development Fund
- National Nurses Union
- National NeighborWorks Association
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club

- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

List of State and Local Signers

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina

- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG

- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET