THE GEORGE WASHINGTON UNIVERSITY

WASHINGTON, DC

Public Interest Comment[1] on
The Securities and Exchange Commission's Proposed Rule:

Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers

File No. S7-05-14

RIN: 3235-AL45

July 1, 2014

Mark Bigley, Summer Fellow[2]

The George Washington University Regulatory Studies Center

Retrospective Review Comment Project

The George Washington University Regulatory Studies Center strives to improve regulatory policy through research, education, and outreach. As part of its mission, the Center conducts careful and independent analyses to assess rulemaking proposals from the perspective of the public interest. This comment on the Securities and Exchange Commission's ("SEC" or "Commission") proposed rule establishing recordkeeping and reporting requirements for security-based swap dealers ("SBSDs"), major security-based swap participants ("MSBSPs"), and broker-dealers does not represent the views of any particular affected party or special interest, but is designed to evaluate whether Commission's proposal incorporates plans for retrospective review, pursuant to Executive Orders 13563 and 13579.

---

[1] This comment reflects the views of the author, and does not represent an official position of the GW Regulatory Studies Center or the George Washington University. The Center's policy on research integrity is available at http://research.columbian.gwu.edu/regulatorystudies/research/integrity.

[2] Mark Bigley is a Summer Fellow at the George Washington University Regulatory Studies Center and can be contacted via e-mail at mbigley@gwu.edu.

Introduction

Title VII ("Title VII") of the Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law by President Barack Obama in July 2010, brought about a new regulatory framework for securities and derivatives traded in over-the-counter ("OTC") markets. The goals of Title VII are to improve the transparency of the OTC market, promote market integrity, and reduce risk. To implement Title VII, the Commission

> is proposing recordkeeping, reporting, and notification requirements applicable to security-based swap dealers ("SBSDs") and major security-based swap participants ("MSBSPs"), securities count requirements applicable to certain SBSDs, and additional recordkeeping requirements applicable to broker-dealers to account for their security-based swap and swap activities. The Commission also is proposing an additional capital charge provision that would be added to the proposed capital rule for certain SBSDs. Finally, the Commission is proposing technical amendments to the broker-dealer recordkeeping, reporting, and notification requirements.[3]

The Commission's proposed regulation establishes recordkeeping and reporting requirements for SBSDs and MSBSPs. The reports required should indicate the transactions of the SBSDs and MSBSPs and their respective positions, as well as their associated financial conditions. In the case of smaller broker-dealers, such as nonbank SBSDs or nonbank MSBSPs with no prudential regulator, the Commission proposes to require records to be kept for a period of time. As for certain larger SBSDs and MSBSPs with a prudential regulator, the proposed rule would require that they also keep records for a certain duration of time, as well as all information relating to their security-based swap transactions and maintain daily trading records.

The Commission assumes that broker-dealers not currently registered as SBSDs or MSBSPs will do so in order to compete in the OTC market, and according to the NPRM will have to abide by the same recordkeeping and reporting requirements proposed in this rule. The Commission also anticipates that certain parties will engage in security-based swaps but will not register as SBSDs and MSBSPs, but must adhere to the proposed standards to the extent that they engage in swaps. In addition, all parties listed above must conform to certain security count requirements, as well as capital, margin, and segregation requirements pertaining to these security-based swaps and clearing parties.

As a part of its ongoing Retrospective Review Comment Project, the Regulatory Studies Center examines significant proposed regulations to assess whether agencies propose retrospective

[3] 79 FR 25194

review as a part of their regulations, and submits comments to provide suggestions on how best to incorporate plans for retrospective review into their proposals. To facilitate meaningful retrospective review after the promulgation of a final rule, multiple government guidelines instruct agencies to incorporate retrospective review plans into their proposals during the rulemaking process.

Incorporating Retrospective Review into NPRMs

Through a series of Executive Orders, President Obama has encouraged federal regulatory agencies to review existing regulations "that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned." On January 18, 2011, President Obama signed Executive Order 13563, Improving Regulation and Regulatory Review, which reaffirmed the regulatory principles and structures outlined in EO 12866. In addition to the regulatory philosophy laid out in EO 12866, EO 13563 instructs agencies to

> consider how best to promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned. Such retrospective analyses, including supporting data, should be released online whenever possible.[4]

This ex-post review makes it possible for the government and the public to measure whether a particular rule has had its intended effect. In his implementing memo on retrospective review, former Administrator of the Office of Information and Regulatory Affairs, Cass Sunstein, stated the importance of designing regulations to facilitate their evaluation:

> With its emphasis on "periodic review of existing significant regulations," Executive Order 13563 recognizes the importance of maintaining a consistent culture of retrospective review and analysis throughout the executive branch. To promote that culture, *future regulations should be designed and written in ways that facilitate evaluation of their consequences* and thus promote retrospective analyses and measurement of "actual results." To the extent permitted by law, agencies should therefore give careful consideration to how best to promote

[4] Exec. Order No. 13563, *Improving Regulation and Regulatory Review*, 76 FR 3821 (2011).

> empirical testing of the effects of rules both in advance and retrospectively.[5] [Emphasis added]

This emphasis is repeated in Sunstein's June 14, 2011 memo, "Final Plans for Retrospective Analysis of Existing Rules." In its 2013 Report to Congress on the Benefits and Costs of Federal Regulations, the Office of Management and Budget (OMB) states that such retrospective analysis can serve as an important corrective mechanism to the flaws of ex ante analyses. According to that report, the result of systematic retrospective review of regulations:

> should be a greatly improved understanding of the accuracy of prospective analyses, as well as corrections to rules as a result of ex post evaluations. A large priority is the development of methods (perhaps including not merely before-and-after accounts but also randomized trials, to the extent feasible and consistent with law) to obtain a clear sense of the effects of rules. In addition, and importantly, *rules should be written and designed, in advance, so as to facilitate retrospective analysis of their effects.*[6]

While Executive Orders generally apply only to the executive branch, President Obama has made it clear that independent agencies should adhere to the same retrospective review principles as executive branch agencies. In his subsequent Executive Order 13579, President Obama recommended that independent regulatory agencies, no less than the executive branch, should promote the goals of EO 13563:

> To facilitate the periodic review of existing significant regulations, independent regulatory agencies should consider how best to promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned.

While the proposed rule does provide an economic analysis of the OTC market and the expected burdens of the rule, it does not attempt to quantify benefits, nor does it provide a strategy or timeframe for the Commission to perform retrospective review. In line with the requirements of EO 13579, OMB's implementation memo, and OMB's 2013 Report to Congress, it is clear that

---

[5] United States. Office of Management and Budget. Office of Information and Regulatory Affairs. *MEMORANDUM FOR THE HEADS OF EXECUTIVE DEPARTMENTS AND AGENCIES: Retrospective Analysis of Existing Significant Regulations*. By Cass Sunstein. April 25, 2011.

[6] 2013 Report to Congress on the Benefits and Costs of Federal Regulations and Unfunded Mandates on State, Local, and Tribal Entities (May 2014)

the SEC should incorporate specific plans for retrospective review and ex post evaluation into the text of its final rule.

Retrospective Review Requirements

To evaluate whether the SEC proposal was "designed and written in ways that facilitate evaluation of [its] consequences," we measure it against five criteria:

- Did the SEC clearly identify the problem that its proposed rule is intended to solve?
- Did the SEC provide clear, measurable metrics that reviewers can use to evaluate whether the regulation achieves its policy goals?
- Did the SEC commit to collecting information to assess whether its measureable metrics are being reached?
- Did the SEC provide a clear timeframe for the accomplishment of its stated metrics and the collection of information to support its findings?
- Did the SEC write its proposal to allow measurement of both outputs and outcomes to enable review of whether the standards directly result in the outcomes that the Commission intends?

Identifying the Problem

The first of the "Principles of Regulation" outlined by President Clinton in EO 12866 makes it clear that, as a first step, agencies must be able to identify the problem that justifies government action through regulation:

> Each agency shall identify the problem that it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action) as well as assess the significance of that problem.

This step is crucial to the formulation of any policy. Without knowledge of the problem that the agency is trying to address, the public cannot assess whether the policy or regulation at hand has had the intended effect, which is key in retrospectively evaluating regulation.

The proposed rule does not explicitly define a market failure as required in EO 12866, but does reference Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act:

> Title VII was enacted, among other reasons, to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things (1) Providing for the registration and regulation of SBSDs and MSBSPs; (2) imposing clearing and trade execution requirements on swaps and security-based swaps, subject to certain exceptions; (3) creating recordkeeping and real-time

> reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to all registered entities and intermediaries subject to the Commission's oversight.[7]

Thus the desired outcomes of the proposed recordkeeping and reporting standards appear to be to reduce risk, increase transparency, and promote market integrity within the financial system.

Measurement Criteria

In order to measure the success of this rule following implementation, it is necessary for the SEC to define what constitutes a "success."

In the NPRM, the Commission does provide a baseline economic analysis of the OTC derivative market as it exists today regarding swaps. The Commission then estimates the burdens and costs of the NPRM with respect to the baseline and qualitatively discusses its impact on efficiency, competition, and capital formation.

The Commission states, it "believes these proposed rules and rule amendments will help regulators determine whether relevant market participants comply with the proposed capital, margin, and segregation requirements."[8] However, the preamble does not give any metrics to effectively measure how well the rule achieves the statutory goal of transparency and stability in the OTC derivative market, or its effect on efficiency, competition, and capital formation.

Information Collection

The proposed rule indicates which broker-dealers, SBSDs, and MSBSPs are to record and report under which standards and estimates the initial and annual burden hours per firm and industry. Cumulatively, the annual burden per industry comes to over 16,000 hours. The Commission asks for public comment regarding the estimates and burdens, as well as suggestions for improving the process.

OMB's Paperwork Reduction Act regulations require agencies to "ensure that each collection of information …informs and provides reasonable notice to the potential persons to whom the collection of information is addressed of … an estimate, to the extent practicable, of the average burden of the collection (together with a request that the public direct to the agency any comments concerning the accuracy of this burden estimate and any suggestions for reducing this burden)."[9]

---

[7] 79 FR 25194-25195

[8] 79 FR 25277

[9] 5 CFR Part 1320.8(b)(3)(iii)

The Commission should use the public comments to evaluate the accuracy of its burden estimates. Further, consistent with the requirements of the Paperwork Reduction Act, the Agencies should commit to collecting the information on market efficiency, competition, capital formation and stability in order to measure the rule's success.

Timeframe

The SEC does not indicate a timeframe for retrospective review in the proposed rule. The Commission should include in the final rule a timeframe regarding retrospective review in order to properly assess the effects of its proposed rule in the OTC market and financial market as a whole.

Measure Linkages

The Commission states it "believes these proposed rules and rule amendments will help regulators determine whether relevant market participants comply with the proposed capital, margin, and segregation requirements." Before issuing a final rule, it should examine how that will support the ultimate objective of improving transparency, reducing risk, and promoting financial market integrity. A better understanding of the causal linkages implicit in the proposal will not only improve the SEC's ability to measure the rule's effects once implemented, but may improve the regulation itself.

Recommendations

The SEC has not clearly identified "the problem that it intends to address (including, where applicable, the failures of private markets or public institutions that warrant new agency action) as well as assess the significance of that problem." The rule implements requirements of the Dodd-Frank Act that are intended to "reduce risk, increase transparency, and promote market integrity within the financial system," however these terms are not defined anywhere in the rule. Thus, the SEC faces a difficult task to identify what constitutes a success with regards to the proposed rule. Unless it can present clearer measures of success than it has in the proposal, the SEC will be unable to "promote retrospective analysis of rules that may be outmoded, ineffective, insufficient, or excessively burdensome, and to modify, streamline, expand, or repeal them in accordance with what has been learned," as required by E.O. 13579.

In identifying measurement criteria to promote retrospective analysis, the Commission should also consider unintended consequences. For example, according to a 2011 Harvard survey of broker-dealers, the overwhelming majority indicated that the Dodd-Frank Act and associated

regulations would have an extensive impact on their compliance program requiring the hiring of additional compliance staff, and compliance with the law poses a challenge to their businesses.[10]

[10] http://blogs.law.harvard.edu/corpgov/2011/10/08/broker-dealers-respond-to-dodd-frank-and-finra/