U.S. Commodity Futures Trading Commission
Office of the Inspector General

An Investigation Regarding Cost-Benefit Analyses Performed by the Commodity Futures Trading Commission in Connection with Rulemakings Undertaken Pursuant to the Dodd-Frank Act

REPORT OF INVESTIGATION

Prepared by the
Office of the Inspector General
Commodity Futures Trading Commission

April 15, 2011

EXECUTIVE SUMMARY

The Office of the Inspector General for the Commodity Futures Trading Commission investigated the formulation of cost benefit analyses for four separate rulemakings recently published by the Commodity Futures Trading Commission:

1. Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010) (Joint proposed rule; proposed interpretations);[1]

2. Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010) (Notice of proposed rulemaking);

3. Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010) (Notice of proposed rulemaking);

4. Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010) (Notice of proposed rulemaking).

We undertook this investigation at the request of Representative Frank D. Lucas, Chairman, House Committee on Agriculture, and Representative K. Michael Conaway, Chairman, Subcommittee on General Farm Commodities and Risk.[2] We were asked to review eight factors in our investigation, and were requested to complete our investigation by April 15, 2011.

In order to complete the investigation, we reviewed drafts of the cost-benefit analyses for the four proposed rules, staff email, and internal memoranda. In addition, we conducted interviews with 24 CFTC employees at staff and various management levels who were involved (or were reported to us as involved) with the cost-benefit analyses processes for the four rules.

The cost-benefit analyses were created as follows. Following enactment of the Dodd-Frank Act,[3] the Chairman and Division Directors created 30 rulemaking teams.[4] Because section 15(a) of the Commodity Exchange Act (the Act)[5] required the consideration of a cost-benefit analysis for each rulemaking, the Office of General Counsel and Office of Chief Economist

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[1] The Commission published this proposed rule jointly with the Securities and Exchange Commission, in consultation with the Board of Governors of the Federal Reserve System. 75 FR 80174 (December 21, 2010).
[2] The request is available here: http://agriculture.house.gov/pdf/letters/cftc_inspectorgeneral110311.pdf
[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act" or "Dodd-Frank").
[4] A 31st team was later created and tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Act. Testimony of Chairman Gary Gensler before the House Committee on Agriculture, February 10, 2011, available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html.
[5] 7 USC sec. 19.

created a uniform methodology for cost-benefit analysis for use Agency-wide. That methodology, contained in a September 2010 memo signed by the General Counsel and the Chief Economist, set out in some detail the types of qualitative considerations that might inform a cost-benefit analysis, encouraged the use of both qualitative and quantitative data, and included a template for everyone to follow.

Although the development of a uniform methodology appeared to be an equal effort between the Office of General Counsel and the Office of Chief Economist, in practice the cost-benefit analyses involved less input from the Office of Chief Economist, with the Office of General Counsel taking a dominant role. For the four rules we reviewed, the cost-benefit analyses were drafted by Commission staff in divisions other than the Office of Chief Economist. Staff from the Office of Chief Economist did review the drafts, but their edits were not always accepted.

Staff in the Office of General Counsel created the first draft of the cost-benefit analysis for the proposed rule defining "swap dealer" and "major swap participant."[6] Staff told us the Office of Chief Economist favored addressing in some manner the operational and compliance costs that would flow from coverage under the definition of "swap dealer" or "major swap participant," but the Office of General Counsel determined only to address the costs and benefits associated with undergoing an examination or other process to determine whether one fell under the definitions, or not.

With regard to the cost-benefit analyses for the proposed rule setting out core principles for designated contract markets,[7] staff explained that the process for this rule went relatively smoothly, with staff in the Office of General Counsel drafting the cost-benefit analysis with some edits from the Office of Chief Economist and from other members of the rule-making team. However, staff from the Designated Contract Market (DCM) core principles team wanted us to know about disputes regarding an earlier rule regarding swap execution facilities. In connection with this other rule, the Office of Chief Economist edited an initial draft created by staff in the Office of General Counsel. To put the dispute in simplest terms, the Office of Chief Economist undertook a cost-benefit analysis that addressed separate tasks set out in various sections of the rule. Staff in the Office of General Counsel strongly encouraged the staff from the Office of Chief Economist not to deviate from accepted methodologies for cost-benefit analyses employed by the Commission for 10 years, which apparently limited the scope of the cost-benefit analysis under section 15(a) to an analysis of the rule as a whole. Staff from the Office of General Counsel opined that deviating from this long-standing standard could result in litigation risk, and that the adoption of a new methodology could require the Commission to engage in the same methodology for future rules (or a litigation risk could result). Inasmuch as the Commission's cost-benefit analyses in rulemakings had never been challenged in court, we consider prior practice in this instance to not carry as much weight as if it had received judicial approval. Moreover, from our review of relevant email and memoranda, it is apparent that other

[6] Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010) (Joint proposed rule; proposed interpretations).
[7] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010) (Notice of proposed rulemaking).

staff within the Office of General Counsel did not appear to embrace this view. In the end, staff in the Office of General Counsel revised the cost-benefit analyses in accordance with its views, which was approved by the team leader and the team leader's boss.

The same team that drafted the proposed rules dealing with portfolio compression and reconciliation[8] also drafted the proposed rule setting out duties for swap dealers and major swap participants.[9] The cost-benefit analysis was created, for both rules, by a sub-set of the rulemaking team, and reviewed by staff in the Office of Chief Economist. A staff member in the Office of Chief Economist who was assigned to the team told us she was not part of the sub-group that created the cost-benefit analysis, and she was not sure she was invited to all relevant meetings for the rulemaking. Instead, she was given drafts to review, and believed the drafts were complete when she received them, and made few edits.

To a greater or lesser extent for the four examined rules, the Office of General Counsel appeared to have the greater "say" in the proposed cost-benefit analyses, and appeared to rely heavily on an historic (and somewhat stripped down) analytical approach. While we offer no opinion on the cost-benefit analyses for the four rules, we note that similar economic analyses in the context of federal rulemaking have proved perilous for financial market regulators.[10] Moreover, it seems odd for an agency that regularly engages in economic analysis. We recognize that cost-benefit analysis does not possess anywhere near the exactitude of, say, calculus, but it does provide structure for evaluation. A more robust process is clearly permitted under the cost-benefit guidance issued by the Office of General Counsel and the Office of Chief Economist, and we believe a more robust approach would be desirable, with greater input from the Office of Chief Economist.

We note that the Chairman has initiated a review and revision of the cost-benefit analysis methodology for use in final rulemakings, and again we recommend that such review should lead to more robust cost-benefit analysis methodologies. We recommend that the Office of Chief Economist take on an enhanced role.

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[8] Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010) (Notice of proposed rulemaking).
[9] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010) (Notice of proposed rulemaking).
[10] See, e.g., *Am Equity Investment Life Ins. Co. v. S.E.C.*, 613 F.3d 166, 177-178 (D.C. Cir.2010); *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133, 142-144 (D.C. Cir.2005).

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BACKGROUND

Section 15(a) of the Commodity Exchange Act

Section 15(a) was added to the Commodity Exchange Act in 2000 with passage of the Commodity Futures Modernization Act (CFMA).[11] Section 15(a) provides:

> (a) Costs and benefits.
>
> (1) In general. Before promulgating a regulation under this Act [7 USCS §§ 1 et seq.] or issuing an order (except as provided in paragraph (3)), the Commission shall consider the costs and benefits of the action of the Commission.
>
> (2) Considerations. The costs and benefits of the proposed Commission action shall be evaluated in light of—
> (A) considerations of protection of market participants and the public;
> (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;
> (C) considerations of price discovery;
> (D) considerations of sound risk management practices; and
> (E) other public interest considerations.
>
> (3) Applicability. This subsection does not apply to the following actions of the Commission:
> (A) An order that initiates, is part of, or is the result of an adjudicatory or investigative process of the Commission.
> (B) An emergency action.
> (C) A finding of fact regarding compliance with a requirement of the Commission.

The legislative history for section 15(a) is sparse, and appears to consist of this brief statement:

> [The CFMA] amends section 15 of the CEA to add a new subsection (a) requiring the CFTC, before promulgating regulations and issuing orders, to consider the costs and benefits of its action. This does not apply to orders associated with an adjudicatory or investigative process, or to emergency actions or findings of fact regarding compliance with CFTC rules.[12]

CFTC first interpreted new section 15(a) in a proposed rule titled "Addressing a New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations":[13]

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[11] Commodity Futures Modernization Act of 2000, section 119, Appendix E, Pub. L. No. 106-554, 114 Stat. 2763 (2000).
[12] This statement is found in 106 H. Rpt. 711; Prt 1, *_____ (June 29, 2000); 106 S. Rpt. 390, *___ (August 25, 2000); and 106 H. Rpt. 711; Prt 3, *___ (September 6, 2000).
[13] 66 FR 14262 (March 9, 2001).

The proposed rule listed the five factors under section 15(a) and provided a brief, qualitative discussion of associated benefits and costs for each factor. The CFTC's approach to cost-benefit analysis under section 15(a) has remained relatively consistent through the years, though the Commission did drop the practice of separately listing the section 15(a) factors. [14] It appears section 15(a) has never been challenged in the courts.

Methodology for Cost-Benefit Analysis Under the Dodd-Frank Act

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act.[15] As described by the CFTC, Title VII of the Dodd-Frank Act amended the Commodity Exchange Act[16] to

> …establish a comprehensive, new regulatory framework for swaps and security-based swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) Providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating robust recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.[17]

The Dodd-Frank Act required the Commission to promulgate regulations to implement the Act by July 15, 2011. CFTC began immediately to work on rule implementation, including the cost-benefit analyses.

From CFTC staff and management, we learned that from the outset the goal was to create a uniform cost-benefit analysis methodology for all Dodd-Frank rulemaking that would comply with section 15(a). Accordingly, the Office of General Counsel and Office of Chief Economist created the following template, which was distributed to staff in September 2010:

[14] See, e.g., Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulation, 75 FR 4144 (January 26, 2010).
[15] Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, 124 Stat. 1376 (2010) ("Dodd-Frank Act" or "Dodd-Frank").
[16] 7 USC section 1, *et seq.*
[17] Core Principles and Other Requirements for Designated Contract Markets; Proposed Rule, 75 FR 80572 (December 22, 2010).

> TEMPLATE
>
> Section 15(a) of the Commodity Exchange Act requires the Commission to consider the costs and benefits of its actions before issuing an order under the Act. By its terms, section 15(a) does not require the Commission to quantify the costs and benefits of rule or to determine whether the benefits of the order outweigh its costs; rather, it requires that the Commission "consider" the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.
>
> Summary of proposed requirements. The proposed rule would [explain briefly the requirements of the rule].[18]
>
> Costs. With respect to costs, the Commission has determined that [draw conclusions about the costs of the rule, associating the appropriate cost-benefit categories either directly or by implication].
>
> Benefits. With respect to benefits, the Commission has determined that [draw conclusions about the benefits of the rule, associating the appropriate cost-benefit categories either directly or by implication].
>
> Public Comment. The Commission invites public comment on its cost-benefit considerations. Commenters are also are invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters.

In addition, the General Counsel and Chief Economist issued the following guidance (the September 10 guidance) to be followed when completing the template:

> In the cost-benefit section of a proposed or interim final rulemaking, an initial analysis of the Commission's views of the costs and benefits of the proposed rule should be presented so that interested parties may submit comments that challenge, defend, or provide additional support for the analysis. A declarative statement of the anticipated effects of the proposed rule should be provided, in addition to requesting that interested parties submit their views on the five cost-benefit considerations enumerated in section 15.

[18] Brackets in original. Bracketed text contains instruction to CFTC staff.

> Typically, the costs typically may be presented by describing a counterfactual – what the Commission expects will happen if the rule is not adopted, with reference to previous or anticipated events. The benefits should be provided in declarative form.
>
> …
>
> The costs discussion in the cost-benefit analysis section of a rulemaking should include a quantitative or qualitative description of the kinds of costs involved, and upon which parties they will be imposed. When presenting costs qualitatively, the costs should be compared to some relevant alternative to the rule (i.e., the benchmark). In many cases, the benchmark would be the status quo regulatory approach. In some contexts, however, an alternative benchmark may be appropriate. If the rulemaking was designed to avoid certain costs associated with an alternative rule that could have been imposed, it should be discussed here as well; essentially comparing the proposed rule to a second benchmark.
>
> …
>
> With respect to the benefits associated with a proposed rulemaking, the comparison should be to the same benchmark(s) identified in the discussion of costs, and again the discussion should highlight the kinds of benefits anticipated, and the likely affected parties.[19]

THE COMMISSION'S COST-BENEFIT ANALYSES FOR FOUR PROPOSED RULES

1. Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010) (Joint proposed rule; proposed interpretations)

The Commission proposed definitions for "swap dealer" and "major swap participant," "major security-based swap participant" in December 2010.[20] With regard to cost-benefit analysis, the "entity definitions rule"[21] separately addressed the costs and benefits for each entity definition.

Discussions with CFTC staff and management and review of email indicate that some debate centered on how to craft the cost-benefit analysis in the context of a definitions rule, including some discussion whether the definitions rule would require much in the way of cost-benefit analysis at all. We were told that staff in the Office of Chief Economist prepared an initial draft that compared the qualitative costs to society of broad or inclusive definitions of

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[19] Memorandum RE: *Guidance on and Template for Presenting Cost-Benefit Analyses for Commission Rulemakings*, September 29, 2010 (attached as Exhibit 1).
[20] Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010).
[21] Staff adopted nicknames for the rules assigned to the 30 rulemaking teams. We are using these nicknames in our report.

these terms versus narrower coverage. This was scrapped in favor of a draft that addressed the costs and benefits of the evaluative processes that market participants might undergo in order to determine coverage. Staff in the Office of General Counsel created the new draft. The Deputy General Counsel who reviewed the second draft was made aware of the earlier discussions but apparently did not review the earlier draft. Few changes were made to the second draft of the cost-benefit analysis.

Staff and management also considered the difficulty to the industry of evaluating and commenting on the proposed entities definitions rule concurrently with conduct rules for the defined market participants. Staff and management were aware that market participants might refrain from comment on conduct regulations in the mistaken belief that they would not fall within the definitions. However, at this stage in the rulemaking process, staff indicated the overriding concern was meeting the rule-making deadline under Dodd-Frank. Staff and management opined that the industry by and large knew that market participants conducting any significant swaps business or trading would expect to fall under the definitions of Swap Dealer, Security-based Swap Dealer, Major Swap Participant, Major Security-based Swap Participant, and Eligible Contract Participant (as appropriate). While market participants on the fringes could be expected to NOT know coverage in anticipation of the final definitions rule, these participants would constitute the minority of market participants eventually covered under the rule. Any market participant anticipating possible coverage under a new Dodd-Frank market participant definition should know to review and offer comment on the conduct rules in anticipation of coverage, staff and management in the Office of General Counsel opined.

Section 712(d)(1) of the Dodd-Frank Act required CFTC and the Securities and Exchange Commission (SEC), in consultation with the Board of Governors of the Federal Reserve System (FRB), to jointly define the terms in this rule. Another concern voiced by staff and management regarding the definitions rule was the additional time necessitated for joint rulemakings with the SEC and FRB. Collaboration would necessarily involve more time. CFTC management determined early on that the additional time necessary for the required collaboration would not permit the definitions to be adopted in advance of conduct rules.

However, in light of the collaborative requirement, an advanced notice of proposed rulemaking was published for this rule (prior to the proposed rulemaking).[22] Over 80 comments were received. The proposed rulemaking does not indicate that commenters on the advanced notice of proposed rulemaking discussed costs associated with the definitions, although several general statements indicating the definitions could lead to greater costs were received.[23] The proposed rulemaking does request further comments regarding costs.

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[22] See, Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act, Exchange Act Rel. No. 34-62717, 75 FR 51429 (Aug. 20, 2010). The comment period closed on September 20, 2010.

[23] See Comments filed by: Hess Corporation, available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26196&SearchText=; Dairy Farmers of America, Inc., available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26190&SearchText= ; Metropolitan Life Insurance Company, available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26178&SearchText=.

In the proposed rule, the cost-benefit analysis[24] states that the costs to market participants associated with the proposed definition of "swap dealer" would arise "primarily from its need to review its activities and determine, as a qualitative matter, whether its activities are of the type described" in the proposed regulation. In addition, market participants would need "to repeat this review" from time to time as its activities change. Because the Commission proposed a quantitative de minimis exception, the costs associated with determining coverage under the exception would be "lower."

Benefits associated with the type of criteria selected by the Commission to indicate coverage would include the presence of a "single set of criteria to be applied by all market participants" which, according to the Commission, would create a "level playing field that permits all market participants to determine, on an equal basis, which activities" would trigger designation as a swap dealer. The benefit associated with a quantified de minimis exemption (and the exclusion of swaps in connection with the origination of loans) is the ability to make a relatively quick and low-cost determination whether the exemption applies.

Likewise, costs associated with the proposed definition of "major swap participant," would "arise primarily" from the expense associated with the analytical process necessary to determine whether the definition applies. The Commission stated it had considered more complex tests, i.e., "market-based tests of potential future exposure such as margin requirements or other valuations of the outstanding position," but opted to "define potential future exposure by a factor of the dollar notational value of the swap." Costs of a detailed analysis "would vary for each market participant."

Under the proposed rule, market participants may request limited designation as a major swap participant, but the costs associated with such requests, according to the Commission, "are difficult to predict because they would depend on the complexity of the particular case." Benefits associated with establishing limited designation as a major swap participant were not discussed.

Benefits associated with the Commission's proposed definition of "major swap participant" include the presence of a "bright-line test that can be applied at a relatively low cost." The Commission also opined that the definition of "hedging or mitigating commercial risk" was general and could be "flexibly applied." The Commission stated it had considered alternative definition methodologies, including "multi-factor analyses, stress tests and adversary processes," but concluded they would result in significantly higher costs without providing equal additional benefits.

The Commission opined that the proposed definition of "eligible contract participant" was "in line with the expectations of market participants and would impose virtually no costs while providing the benefit of greater certainty." To the extent the proposal would also clarify that certain commodity pools could not qualify as eligible contract participants under certain provisions, the Commission stated that while this clarification would potentially impose some

[24] 75 FR 80173, 80203-80205 (December 21, 2010).

costs on the commodity pools that could no longer rely on certain provisions of the definition, benefits would arise from preventing the misinterpretation of the definition.[25]

Generally speaking, it appears CFTC employees did not consider quantifying costs when conducting cost-benefit analyses for the definitions rule. As indicated in the rule's preamble, the costs and benefits associated with coverage under the various definitions (in light of the various regulatory burdens that could eventually be associated with coverage) were not addressed, and instead the cost-benefit analysis addressed the relative costs and benefits of undergoing the process of determining coverage. Costs of *being* covered would emanate from the business conduct requirements adopted through other rules.

We note that, in the same proposed rule, the Securities and Exchange Commission did opt to include in their analyses of costs associated with coverage under the definitions of "security-based swap dealer" and "major security-based swap participant," costs associated with the regulatory requirements associated with inclusion, e.g., the registration, margin, capital, and business conduct requirements. While the SEC acknowledged that the costs and benefits associated with compliance with regulatory requirements would be addressed in the separate rules, it welcomed comment on costs and benefits of the definitions "in that broader context."[26]

The comment period for this proposed rule closed on February 22, 2011.

2. Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010) (Notice of proposed rulemaking)

The Commission proposed confirmation, portfolio reconciliation, and compression requirements for swap dealers and major swap participants in December 2010.[27] Section 731 of the Dodd-Frank Act added to the Commodity Exchange Act new section 4s(i), a requirement that all swap dealers and major swap participants adhere to standards adopted by the Commission relating to confirmation, processing, netting, documentation and valuation of all swaps. The team assigned to this rule called this one "the compression rule." Not all members of the team were assigned to the drafting of this rule.

Team members assigned to the compression rule explained their belief that the regulations proposed by the Commission would build upon work begun several years earlier. In 2005 the Commission participated in the OTC Derivatives Supervisors' Group (ODSG. Lead by the Federal Reserve Bank of New York, the ODSG had for several years encouraged the industry to perform many of the tasks now being committed to regulation. Team members believed the industry had complied with the efforts of the ODSG, that the proposed regulations did not impose further tasks or duties, and therefore the costs of compliance with new regulations that clarified now-current practices would be minimal. Staff were aware that start-up costs for those

[25] *Id.*, 75 FR at 80203-80205.
[26] *Id.*, 75 FR at 80207.
[27] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010).

entities that had not followed ODSG-encouraged practices might be significant. Staff indicated they had recently received comments from Markit[28] offering further insight into costs associated with this rule.[29] CFTC staff met with representatives of Markit in March 23, 2011 to discuss the compression rule.[30]

Staff also told us that costs were addressed during discussions regarding the technical aspects of the rule. They pointed out that they requested comments on:

- ways to reduce the burdens associated with confirmation, reconciliation and compression for the swaps market;[31]
- the feasibility of staggered or delayed effective dates for some regulations, (recognizing that some entities may not have the capacity to comply with the new regulations as quickly as the larger, established swap dealers and major swap participants);[32]

Staff stated that, in an effort to lessen potential costs of compliance, the proposed rule did not prescribe a particular venue or platform for confirmation.[33] Staff stated discussions regarding how to avoid unnecessary or minimize compliance costs were considered during the team's process of formulating the proposed compression rule. Staff explained that the benefits of portfolio compression were discussed in the text of the preamble, separate from the cost-benefit analysis section.[34]

The cost-benefit analysis section was created by a subset of the team, using the September 2010 guidance and template created by the Office of General Counsel and Office of Chief Economist.[35] Discussions with staff and management on the team and review of email indicate that there were no significant debates regarding the approach to take with regard to the cost-benefit analysis section. However, staff in the Office of Chief Economist were not sure that they were invited to all relevant meetings connected with this rulemaking and stated that, for this rule, they reviewed the cost-benefit analysis section without drafting it or having significant input. Staff in the Office of Chief Economist at that time were also concerned with the order of rulemaking, expressing concern that formal adoption of the definitions for "swap dealer" and "major swap participant" should precede adoption of regulations governing them.

In any event, the cost-benefit analysis characterized the costs of compliance as "nominal" and "minimal" because the confirmation, reconciliation and compression processes are already part of compliance practices that "many, if not most, swap dealers and major swap participants already undertake as part of their ordinary course of business." The cost-benefit analysis also stated that "most" swap dealers and major swap participants have adequate resources and existing back office systems to accommodate any changes necessitated by the new rules "without

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[28] Markit is a financial information services company providing independent data, valuations, trade processing, loan portfolio management, and other services. www.markit.com.
[29] Available at: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=30669&SearchText=markit.
[30] Meeting details are available here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=32274&SearchText=markit.
[31] 75 FR 81519, 81521 (December 28, 2010).
[32] *Id.* 75 FR at 81521-81522.
[33] *Id.* 75 FR at 81523.
[34] *Id.* 75 FR at 81525.
[35] See Exhibit 1.

material diversion of resources away from commercial operations." Third party vendors are also available, and to the extent the pay per unit (i.e., number of swaps processed), the costs "would be necessarily proportionate to the benefit."

The benefits associated with the compression rule included "reduced risk, increased transparency, and greater market integrity" for swaps, as well as furtherance of the goal of "avoiding market disruptions and financial losses to market participants and the general public." The cost-benefit section also stated the compression rule would "promote levels of operational scalability and resilience that are most evident in periods of sustained high volume and market volatility."

The comment period for this rule closed on February 22, 2011.

3. Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010) (Notice of proposed rulemaking)

Section 723(a)(3) of the Dodd-Frank Act added section 2(h)(8) of the Commodity Exchange Act to require, among other things, that execution of swaps subject to clearing under the Commodity Exchange Act must occur either on a Designated Contract Market (DCM) or on a swaps execution facility. The Commission published its proposed rule governing core principles and other requirements for designated contract markets on December 22, 2010. The proposed rules added five new core principles for trading futures and option contracts, and required DCMs that list standardized swaps for trading to comply with the same core principles applicable to trading futures contracts. The proposed rule also replaced certain "guidance and acceptable practices" with regulations. The proposed rule included several procedural changes for application for designation as a contract market, including abandonment of expedited procedures.

With regard to the cost-benefit analyses for the DCM core principles rule,[36] staff explained that the process for this rule went relatively smoothly, with staff in the Office of General Counsel drafting the cost-benefit analysis with some edits from the Office of Chief Economist and from other members of the rule-making team. However, staff from the team wanted us to know about disputes regarding an earlier rule addressing swap execution facilities. In connection with the earlier rule, the Office of Chief Economist edited an initial draft created by staff in the Office of General Counsel. To put the dispute in simplest terms, the Office of Chief Economist undertook a cost-benefit analysis that addressed costs associated with separate tasks set out in various sections of the rule. Staff in the Office of General Counsel strongly encouraged the staff from the Office of Chief Economist not to deviate from accepted methodologies for cost-benefit analyses employed by the Commission for 10 years, which apparently limited cost-benefit analysis to the rule as a whole. Staff from the Office of General Counsel opined that litigation risk could result from deviating from this long-standing standard, and that the adoption of a new methodology could require the Commission to engage in the same methodology for future rules (or a litigation risk could result). Inasmuch as the Commission's

[36] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010) (Notice of proposed rulemaking).

cost-benefit analyses in rulemakings had never been challenged in court, we consider prior practice in this instance to not carry as much weight as if it had received judicial approval. Moreover, from our review of relevant email and memoranda, it appears that other staff within the Office of General Counsel did not embrace this view. In the end, staff in the Office of General Counsel performed additional edits to the cost-benefit analyses, which was approved by the team leader and the team leader's boss.

The cost-benefit analysis of the DCM core principles rule stated that compliance with core principles for swaps trading on DCMs is "mandatory under the Dodd-Frank Act, and any additional costs associated with these procedures are required by the implementation of the Dodd-Frank Act."[37] The Commission recognized that, while the new regulations (replacing certain guidance and acceptable practices with regulations) generally codify existing industry practice, they may impose "some costs" on DCMs. With regard to abandonment of former expedited procedures for DCM applicants (resulting in additional costs associated with longer procedures), the Commission stated that "few DCMs have been eligible for designation under the expedited procedures, so these costs should be limited."

With regard to benefits, the Commission stated that transaction of swaps on DCMs will result in competition that will "benefit the marketplace." The Commission stated that "the ability to trade standardized swaps openly and competitively additionally will provide market participants with enhanced price transparency resulting in greater protection of market participants and the public." The new and amended core principles would, in the Commission's view, benefit the public by further enhancing the transparency and integrity of futures and options markets as well as swap markets on DCMs. Replacing former guidance and acceptable practices will benefit DCMs and the public by providing "regulatory certainty," and changes to the procedures for applying for designation as a contract market would "benefit new applicants by improving the workability and efficiency of the application process."

Certain staff on the DCM core principles rule team stated that they did not expect a lot of comments regarding costs because they believed they were putting into regulation practices that were already common in the industry. They stated that costs were a consideration during the rulemaking process, volunteering that they had attempted to take a flexible approach to compliance when possible, such as with regard to provisions for block trading and emergency procedures. They were aware the Chicago Mercantile Exchange and other commenters had raised the issue of costs in comments filed in response to the proposed rulemaking.[38] The Minneapolis Grain Exchange also suggested the proposed regulation may result in unnecessary costs,[39] as did the NYCE LIFFE U.S.[40]

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[37] Commissioner Sommers and Commissioner O'Malia dissented from the Commission's action to propose these regulations based on a disagreement with the Commission's interpretation of Core Principle 9 – *Execution of Transactions*. The cost-benefit analysis is not addressed in this dissent. The text of the dissent may be found here: http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement120110b.html.
[38] The CME's comment may be found here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27876&SearchText=costs.
[39] The Minneapolis Grain Exchange's comment may be found here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27908&SearchText=costs.
[40] The NYSE LIFFE US's comment may be found here: http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27910&SearchText=costs.

On March 14, 2011, CFTC extended the original comment period for this rulemaking of February 22, 2011, to April 18, 2011.[41]

4. Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010) (Notice of proposed rulemaking)

Section 731 of the Dodd-Frank Act added new section 4s(j) to the Commodity Exchange Act. Section 4s(j) set forth certain duties for swap dealers and major swap participants, and the Commission proposed regulations pertaining to duties for swap dealers and major swap participants in November 2010.[42] The nickname assigned to this rule by CFTC staff was "the duties rule." The duties rule for swap dealers and major swap participants was handled by the same team that created the compression rule.[43]

While the compression rule had a narrower focus, the duties rule more broadly addressed risk management infrastructure. That is, the duties rule set out the monitoring and other procedures associated with risk management (so-called "back office operations") a swaps dealer or major swaps participant would need in place in order to "do" swaps. CFTC staff and management indicated that, as with the compression rule, the duties rule would commit to regulation practices previously encouraged by the OTC Derivatives Supervisors' Group, lead by the Federal Reserve Bank of New York. While the preamble to the duties rule does not discuss the OTC Derivatives Supervisors' Group, the preamble to the compression rule does state that the OTC Derivatives Supervisors' Group "regularly set goals and commitments to bring risk management improvements to all OTC derivatives asset classes."[44]

Because the industry had begun performing many of the duties set out in the rule, the team did not anticipate that the duties rule would add additional costs for much of the industry. They were aware that entities falling under the definitions of "swap dealer" and "major swap participant" for the first time would face new costs.

As with the compression rule, the team stated that costs associated with compliance with the more detailed aspects of the regulation were discussed during the rulemaking process. For instance, team members stated that costs were discussed in connection with regulations affecting audit trail and pre-trade documentation. They discussed permissible delays in documentation balanced against the need for the certainty (and avoidance of backlogs) afforded through faster (and more expensive) processing.

Staff pointed to spots in the preamble to the proposed rule where they indicated the extent to which costs had been considered. For instance, staff noted that the preamble stated --

[41] 76 FR 14825 (March 18, 2011).
[42] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010) (Notice of proposed rulemaking).
[43] Confirmation, Portfolio Reconciliation, and Portfolio Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 38, 2010).
[44] *Id*,. 75 FR at 81520.

> [T]he Commission recognizes that there will be differences in the size and scope of the business of a particular swap dealers and major swap participants. Therefore, comments are solicited on whether certain provisions of the proposed regulations should be modified or adjusted to reflect the differences among swap dealers or major swap participants.[45]

--as well as

> The Commission recognizes that an individual firm must have the flexibility to implement specific policies and procedures unique to its circumstances. The Commission's rule has been designed such that the specific elements of a risk management program will vary depending on the size and complexity of a swap dealer's or major swap participant's business operations. Risk management policies are expected to provide for appropriate risk measurement methodologies, compliance monitoring and reporting, and on-going testing and assessment of the overall effectiveness of the program.[46]

--and

> The Commission also invites comments regarding an appropriate effective date for this regulation given the amount of time and cost that may be necessary for implementation of a comprehensive business continuity and disaster recovery plan.[47]

Team members stated that the cost-benefit analysis section of this proposed regulation was drafted by a team member very early in the process, and prior to creation of the September 2010 guidance. The first draft generally followed the format generally used for cost-benefit analysis following passage of section 15(a), and presented a qualitative analysis of costs and benefits under the section 15(a) factors.

Staff indicated that the second draft of the cost-benefit analysis was performed by a few members of the team. Comparison of the first draft and the published cost-benefit analysis indicated edits designed to conform the first draft to the template issued in September 2010. As with the compression rule, the team member from the Office of the Chief Economist did not participate with the drafting process, and is not certain that she was invited to all relevant meetings. The draft was reviewed by the team member assigned from the Office of Chief Economist and the Office of General Counsel, and no staff reported significant problems or disputes.

The cost-benefit analysis for the duties rule did include quantified costs.[48] The estimated annual cost to implement a comprehensive risk management program for swap dealers and major swap participants was $20,450.00 (each), or 204.5 hours at an hourly rate of $100/hour. One wonders how compliance cost estimates for swap dealers and major swap participants could be identical, given the differences between those two types of market participants. Moreover, the

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[45] *Id.*, 75 FR at 71398.
[46] *Id.*, 75 FR at 71399.
[47] *Id.*, 75 FR at 71401.
[48] *Id.*, 75 FR at 71403.

Paperwork Reduction Act (PRA)[49] discussion also estimated 204.5 hours for swap dealers and major swap participants "to generate, maintain, or provide information to or for a Federal Agency."[50] In any event, the basis for the estimated cost to implement a comprehensive risk management program is not given, and appears to be an error. The hourly rate of $100/hour was explained in the PRA discussion, and it was based on statistics published by the Bureau of Labor.

Under the heading, "Costs," some benefits are listed. The "Costs" section includes the statement: "the new regulatory requirements are far outweighed by the benefits to the financial system as a whole," and:

> For example, a swap dealer or major swap participant would need to consider, among other things, the experience and qualifications of relevant risk management personnel, as well as the separation of duties among personnel in the business unit, when designing and implementing its risk management policies and procedures. These considerations would help facilitate the development of a risk management program that appropriately addresses the risks posed by the swap dealer's or major swap participant's business and the environment in which such business is being conducted. In addition, these considerations would guide a swap dealer or major swap participant in the implementation of specific policies and procedures unique to its circumstances.

As with the compression rule, the cost-benefit section of the duties rule stated:

> Most swap dealers and major swap participants have adequate resources and existing risk management structures that are capable of adjusting to the new regulatory framework without material diversion of resources away from commercial operations.

CROSS-CUTTING ISSUES ASSOCIATED WITH THE FOUR PROPOSED RULES

For the four proposed rules we were requested to investigate, we identified several cross-cutting concerns raised by CFTC staff and management, and raised by our Office. Issues raised across the board by CFTC staff and management include:

1. Unprecedented Nature of the Regulatory Initiative/Paradigm Shift.

From all CFTC divisions, the staff and management emphasized that Dodd-Frank required regulation of the swaps industry for the first time and therefore presented unprecedented challenges. Calculating costs to establish a swaps execution facility, for instance, which had never before existed under CFTC regulations, was described as a formidable challenge. Staff hoped to obtain cost estimates in comments submitted in response to the proposed rules. Staff indicated that comments were currently being assessed.

[49] 44 U.S.C. chapter 35; see 5 C.F.R. Part 1320.
[50] *Id.*, 75 FR at 71402 (quoting 44 U.S.C. 3502(2)).

2. Historic Difficulty of Quantifying Industry Costs.

Staff and management agreed that, historically, the industry has not presented the CFTC with quantified costs associated with compliance with existing or proposed regulations. Staff opined that the industry considers compliance costs to be proprietary and confidential information. Consequently, staff opined that commenters would be highly unlikely to quantify projected costs for compliance in the context of a federal rulemaking due to the fact that comments are made available to the public. CFTC staff stated they were certain that the industry has calculated its projected costs; however, there is no requirement to disclose cost information to the CFTC in connection with the proposal and adoption of a rule.

3. Frustration with Confusion Surrounding the Paperwork Reduction Act.

Staff expressed some frustration with a perceived confusion of costs listed under the PRA[51] section of the proposed rules as compared with the cost-benefit analysis. PRA only requires a tally of costs associated with completing and filing forms, but does not require other costs associated with completion of forms, such as legal and supervisory review. PRA costs necessarily will be lower than overall costs to complete forms, and lower than overall compliance costs. Staff did express a desire to better explain PRA in the future. We agree.

4. Need to Avoid Addressing Costs and Benefits for the Mandatory Aspects of Dodd-Frank.

To the extent the Dodd-Frank Act imposed mandatory requirements, staff uniformly stressed a desire to refrain from expressing mandatory rules in terms of costs and benefits. If Congress required certain conduct, then Congress necessarily had determined that the benefits would outweigh costs.

5. Costs were Considered During the Process of Constructing the Dodd-Frank Rules.

Staff on the rule-making teams stressed that costs were considered during the rulemaking process. In both internal discussions and meetings with industry representatives[52] costs were raised with a view to determining how to implement requirements that would result in less cost without sacrificing legitimate regulatory needs. Staff had difficulty quantifying time devoted to cost-benefit analysis for this reason.

In addition, our Office identified the following issues that applied to all four rulemakings we reviewed:

[51] 44 U.S.C. chapter 35; see 5 C.F.R. Part 1320.
[52] CFTC has had at least 675 meetings with outside individuals concerning the Dodd-Frank rules. Testimony of Chairman Gary Gensler before the Senate Committee on Banking, Housing and Urban Affairs, available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-77.html.

1. Section 15(a) Compliance was Grouped with PRA and Regulatory Flexibility Act Discussions.

For all four rules we were asked to examine, the cost-benefit analysis was placed at the end of the preamble to the proposed text of the regulation, next to the PRA discussion and the Regulatory Flexibility Act discussion. These three portions were considered non-technical and we got the impression that, prior to enactment of Dodd-Frank, they were generally the province of the Office of General Counsel rather than the CFTC staff tasked with crafting the technical details of a rule. The cost-benefit analysis, PRA discussion, and Regulatory Flexibility Act discussion was referred to by team members as the regulation's "caboose." This treatment of the cost-benefit analysis discussion might have given the impression that it was merely an administrative task associated with the rulemaking, rather than a substantive analysis of the rule.

2. Nobody Quantified Internal Costs Associated with Rule Implementation by CFTC.

Across the board, staff and management alike indicated that CFTC's internal costs were not calculated for purposes of analyzing the costs and benefits associated with the four proposed rulemakings. CFTC management stated that staff labor necessary to implement Dodd-Frank had been calculated overall by each Division, and these quantified estimates were included in CFTC budget submissions, but the cost to implement each regulation had not been quantified. Implementation costs were not reflected in the cost-benefit analyses for the four rules requested for investigation, or in any other rules we reviewed. CFTC also did not quantify or estimate opportunity costs, that is, the extent to which implementation of Dodd-Frank with existing staff would be expected to diminish regulatory efforts in other areas. We would note that Executive Order (EO) 12866 recommended the consideration of costs to the government of enforcement as part of the process of regulatory analysis.[53]

DEVELOPMENTS FOLLOWING PUBLICATION OF THE FOUR PROPOSED RULES

CFTC published the four rules suggested for this investigation between November 23, 2010 and December 28, 2010. On January 18, 2011, President Obama issued EO13563,[54] which states, among other things:

> [e]ach agency is directed to use the best available techniques to quantify anticipated present and future benefits and costs as accurately as possible. Where appropriate and permitted by law, each agency may consider (and discuss qualitatively) values that are difficult or impossible to quantify, including equity, human dignity, fairness, and distributive impacts.
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> ***
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> Where relevant, feasible, and consistent with regulatory objectives, and to the extent permitted by law, each agency shall identify and consider regulatory

[53] EO 12866 (September 30, 1993), 58 FR 51735, 51736 (October 4, 1993).
[54] 76 FR 3821 (January 18, 2011).

> approaches that reduce burdens and maintain flexibility and freedom of choice for the public.[55]

By its terms, EO 13563 did not apply to the CFTC. The Office of General Counsel briefed the CFTC Chairman on this new Executive Order. In light of instructions contained in EO 13563, CFTC created a new Dodd-Frank rulemaking team tasked with developing conforming rules to update the CFTC's existing regulations to take into account the provisions of the Act. [56]

Also in 2011, and as detailed in the March 11, 2011 letter requesting this investigation, cost-benefit analyses issued by the CFTC in connection with the Dodd-Frank rulemakings were subjected to various degrees of criticism by members of Congress, CFTC Commissioners, the industry, and the media.

On March 14, 2011, CFTC extended the original comment period for the DCM Core Principles rulemaking from February 22, 2011, to April 18, 2011.[57] CFTC also extended the comment period for proposed rules addressing risk management requirements for derivatives clearing organizations.[58] It does not appear that CFTC has published notice of an extension to file comments for any other proposed rules issued in accordance with the Dodd-Frank Act. The CFTC Chairman, however, told us that CFTC is accepting late comments as they are received.

The Chairman has informed us that he has directed the Office of General Counsel and Office of Chief Economist to provide guidance to staff for addressing cost-benefit analysis in final rules under Title VII of the Dodd Frank Act, including responding to public comments. It will assist teams in presenting the costs and benefits of final rules under Title VII of Dodd Frank and will incorporate elements of EO 13563.

ANALYSIS OF THE EIGHT FACTORS POSED BY CHAIRMAN LUCAS AND CHAIRMAN CONAWAY

1. The methodologies the CFTC uses to evaluate costs and benefits

This factor is fully addressed at pages six through 8 of this report.

As stated earlier, CFTC began an initiative to rework and improve the cost-benefit methodology under section 15(a). This enhancement to the existing policy overhaul was motivated by comments received to proposed Dodd-Frank rules, as well as criticisms of the cost-benefit analyses from the media and other sources. We understand the process of amending the cost benefit analysis methodology is currently ongoing.

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[55] *Id.*
[56] Testimony of Chairman Gary Gensler before the House Committee on Agriculture, February 10, 2011. Available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-68.html.
[57] Comments Extension: 17 CFR Parts 1, 16, and 38 Core Principles and Other Requirements for Designated Contact Markets, 76 FR 14825 (March 18, 2011).
[58] Comments Extension: 17 CFR Part 39 Risk Management Requirements for Derivatives Clearing Organizations, 76 FR 16587 (March 24, 201).

2. Whether the sequence by which rules are proposed impacts the CFTC's ability to adequately evaluate costs and benefits

CFTC staff and management opined that, with regard to the definitions for both swaps and major swap participants, industry participants should broadly be aware of expected coverage of common terms. However, staff is aware that "fringe" products and industry participants are anticipating these rules. Agency staff and management are of the view that individuals and entities that anticipate possible coverage should review and comment on all rules that may apply. The CFTC Chairman has stated that no rules adopted under Dodd-Frank will be adopted prior to adoption of the definition rules that are currently proposed.

3. The extent to which, in light of budget constraints, the CFTC has sought outside input and expertise in evaluating costs and benefits

We are not aware of any entity or individual hired by CFTC specifically to assist with cost-benefit analyses under Dodd-Frank. The Chairman stated that CFTC has consulted individuals and entities in the course of numerous meetings held in connection with the Dodd-Frank rulemaking effort and noted on the CFTC website. Staff indicated that costs were addressed in both internal and public meetings in the course of the rulemaking effort.

4. The extent to which the CFTC has evaluated and distinguished the costs and benefits of proposed regulations on market participants of diverse sizes and from diverse sectors.

We did not encounter examples of CFTC requesting comment specifically aimed at smaller entities. However, staff stated that costs were discussed during the process of drafting the regulations, including costs for smaller entities. For instance, with regard to the compression rule,[59] team members told us that costs were discussed during meetings regarding the technical aspects of the rule. They pointed out that they requested comments on ways to reduce the burdens associated with confirmation, reconciliation and compression for the swaps market. They told us that, in an effort to reduce the potential burden on compliance, they requested comments on the feasibility of staggered or delayed effective dates for some regulations, and recognized that some entities may not have the capacity to comply with the new regulations as quickly as swap dealers and major swap participants. Staff stated that, in an effort to lessen potential costs of compliance, presumably for smaller as well as larger entities, the proposed rule did not prescribe a particular venue or platform for confirmation. Staff stated discussions regarding how to avoid unnecessary or minimize compliance costs were considered during the team's process of formulating the proposed compression rule.

With regard to the DCM core principles rule,[60] team members stated that costs were a consideration during the rulemaking process, volunteering that they had attempted to take a flexible approach to compliance when possible, presumably to accommodate smaller (and larger) entities. For instance, staff said they suggested a flexible approach regarding block trading and emergency procedures.

[59] Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010).
[60] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010).

In the notice of proposed rulemaking for the duties rule,[61] the Commission stated:

> [T]he Commission recognizes that there will be differences in the size and scope of the business of a particular swap dealers and major swap participants. Therefore, comments are solicited on whether certain provisions of the proposed regulations should be modified or adjusted to reflect the differences among swap dealers or major swap participants.

5. The extent to which the CFTC gives special consideration to evaluating the costs and benefits for small businesses

Again, we found no indication that CFTC gave special consideration to evaluating the costs and benefits for small businesses (above and beyond the Regulatory Flexibility Act[62] statements), other that the statements from staff discussed above in response to the fourth question, discussed above.

6. The amount of time, on average, that Commission staff spent per rule evaluating costs and benefits as required by 15(a)

Obtaining an average time Commission staff spent per rule evaluating costs and benefits was not easy. We asked the team leaders to identify the individuals who had drafted the cost-benefit sections for the four rules, and then sat down with those individuals. If those individuals named other team members who had assisted with the cost-benefit analysis section, we interviewed those individuals as well, and so forth. Occasionally we encountered an individual named as an author or co-author of the cost-benefit analysis who told us he (or she) had done no drafting. From these individuals we learned that every team member reviewed every rule, including the cost-benefit analysis section; however, if cost-benefit analysis wasn't the focus of your work for the team, time spent reviewing it would be minimal. We questioned team members (from all Divisions) and team leaders. We have not included time spent by management in the Office of General Counsel or Division Directors on the cost benefit analyses.

Staff time devoted to cost benefit analyses for the four rules follows:

1. Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant."

For the definitions rule for swap dealers and major swap participants,[63] the team member who crafted the first draft worked in the Office of General Counsel, and estimated he spent approximately 20 hours creating the first draft. The team member from the Office of Chief Economist estimates he spent approximately 3 to 4 hours reviewing and editing the draft cost-

[61] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010).
[62] 5 U.S.C. sec. 601, et seq.
[63] Further Defining "Swap Dealer," "Security-based Swap Dealer," "Major Swap Participant," "Major security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010).

benefit analysis. The team leader stated that she spent minimal time on the cost-benefit analysis, and spent most of her time on the technical aspects of the proposed rule.

2. Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants.

and

4. Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants.

The same Dodd-Frank rulemaking team handled both the compression rule[64] and the duties rules for swaps dealers and major swaps participants.[65] With regard to the duties rule, the first draft of the cost-benefit analysis was created by a team member from the Division of Clearing and Intermediary Oversight, based on prior cost-benefit analyses published following passage of section 15(a) but before the September 2010 guidance issued for the Dodd-Frank rulemaking teams.[66] That first draft took about an hour and a half.

Following issuance of the September 2010 template, a sub-team undertook to create a second draft of the cost-benefit analysis for the duties rule. We were not able to ascertain the identities of the sub-team that undertook the second draft. A team member from the Office of General Counsel indicated that he spent couple hours editing the second draft.

The cost-benefit analysis for the compression rule was also drafted by a sub-team. We were unable to pin down which members of the team comprised the sub-team that created the first draft. Consequently, our time estimate for the cost-benefit analysis for the compression rule and the duties rule likely is not complete. A member of the team from the Office of General Counsel indicated he spent a couple hours reviewing the cost-benefit analysis section for each rule after it was drafted. The team leader for both the duties and compression rules estimated she spent approximately five to 10 hours working on the cost-benefit analysis section for each rule, but stressed that costs and benefits were also discussed at various points during the rule-making process.

The team member from the Office of Chief Economist stated she did not spend a great deal of time on the cost-benefit analyses for the compression and duties rules because she believed they were complete when she received it. She was not sure she was invited to all relevant meetings for either rule. She indicated that during that period she was reviewing a great deal of draft proposed rules under Dodd-Frank for multiple teams, often with quick turn-around times. She was not a part of the sub-team that drafted the cost-benefit analysis for the duties rule or the compression rule.

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[64] Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010).
[65] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010).
[66] See Exhibit 1.

3. Core Principles and Other Requirements for Designated Contract Markets.

With regard to the DCM core principles rule, the team member (from the Office of General Counsel) who drafted the cost-benefit analysis stated she spent approximately a half day working on the cost-benefit analysis for about a week (roughly 20 hours), and spent additional time dealing with revisions suggested by the team member from the Office of Chief Economist. The team member from the Office of Chief Economist told us he spent a great deal of time on the cost-benefit analysis section of the rule, but could not give us a precise number of hours. He also stated that costs were considered throughout the rulemaking process. The team leader for the definitions rule stated that he reviewed drafts of the entire rule throughout the process, but did not spend significant time editing the cost-benefit analysis section.

7. When one proposed rule is highly dependent on another, as is often the case in Title VII, the extent to which the CFTC gives consideration to the impact preceding or subsequent rules may have on the costs or the benefits of the rule under consideration

CFTC management asked about this factor indicated the same approach as to the situation created with proposed definitions rules preceding conduct rules for defined entities and products. Again, where a rule must be created in cooperation with other Agencies, these rules necessarily would run on a different schedule in order to assure compliance with the deadline for the Dodd-Frank rulemaking. Staff also stated that, to a very great extent, the rules are setting out in regulation what the industry has been moving toward for a number of years. The Chairman stressed that the definitions would be finalized prior to rules hinging on the final definitions. He also stressed that CFTC was continuing to receive comments past the rule closing dates, which presumably would permit commenters to respond in light of subsequently published related proposed rules. On March 16, 2011, the Chairman set out with some specificity his plans to issue Dodd-Frank rules in three stages structured to avoid adverse impact to the industry.[67]

8. The impact the current statutory deadline of Title VII has on the Commission's ability to conduct meaningful cost-benefit analysis and the extent to which an extension of the statutory deadline would improve the Commission's ability to consider the costs associated with proposed rules

As stated, above, the Chairman has determined not to adhere to the Dodd-Frank deadline and instead has initiated a structured approach, with intended promulgation of all rules by early Fall.[68] Presumably, this should permit a more extensive cost-benefit analysis of various rules to be employed.

[67] Gary Gensler, Remarks, "Implementing the Dodd-Frank Act," FIA's Annual International Futures Industry Conference, March 16, 2011; available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-73.html.
[68] Id.

CONCLUSIONS AND RECOMMENDATION

Since enactment of the Dodd-Frank Act, CFTC has published more than 50 proposed rules, notices, or other requests related to the new law.[69] In accordance with section 15(a) of the Act, CFTC has published cost-benefit analyses with each proposed rule. We examined the cost-benefit analyses for four proposed rules dealing with definitions,[70] swaps portfolio compression and reconciliation,[71] DCM core principles,[72] and duties for swap dealers and major swap participants.[73]

While the methodology initially adopted by the Office of General Counsel and the Office of Chief Economist[74] would permit a detailed and thorough approach to the task, in the four proposed rules we examined it appears the Commission generally adopted a "one size fits all" approach to section 15(a) compliance without giving significant regard to the deliberations addressing idiosyncratic cost and benefit issues that were shaping each rule, and were often addressed in the preamble.

In our view, two analytical processes proceeded on separate tracks during the construction of each of the four rules. One the one hand, team members devoted to the technical aspects of the rule considered costs (and benefits) associated with the details of the proposed rule's specific instructions. Separately, other team members, who (often) were not as involved with the technical aspects of the proposed rule, drafted cost-benefit analyses in accord with the September 2010 guidance, and the cost-benefit analyses did not always appear to us to acknowledge the cost issues addressed by the technical side of the rule-making team. Even when the technical staff on a given team drafted the cost benefit analysis for a rule, which was the case for the duties rule and the compression rule, it appears that the economic factors considered and embraced or rejected during the course of constructing the rule were not included in the cost-benefit analysis, and instead the cost-benefit analysis was given an homogenized treatment. This separation was demonstrated in the placement of the cost-benefit analysis with the proposed rules' "caboose." Where costs of compliance with duties for swap dealers and major swap participants were quantified in some detail, the basis for the data was not provided.

Other aspects of the cost-benefit analyses gave us pause during our review. The confusion between cost-benefit analyses and the required PRA statement was troublesome. While PRA necessarily requires calculation of some costs associated with compliance, it does not present a complete (or even substantial) estimate. This needs to be better explained in proposed and final rules.

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[69] Statement of Jill E. Sommers, Commissioner, Commodity Futures Trading Commission, Before the Subcommittee on Oversight and Investigations, House Committee on Financial Services, March 30, 2011, available at: http://financialservices.house.gov/media/pdf/033011sommers.pdf .
[70] Further Defining "Swap Dealer", "Security-based Swap Dealer", "Major Swap Participant," "Major Security-based Swap Participant," and "Eligible Contract Participant," 75 FR 80174 (December 21, 2010).
[71] Confirmation, Portfolio Reconciliation, Compression Requirements for Swap Dealers and Major Swap Participants, 75 FR 81519 (December 28, 2010).
[72] Core Principles and Other Requirements for Designated Contract Markets, 75 FR 80572 (December 22, 2010).
[73] Regulations Establishing and Governing the Duties of Swap Dealers and Major Swap Participants, 75 FR 71397 (November 23, 2010).
[74] See Exhibit 1.

We were also troubled at the lack of available (and verified) data pertaining to compliance costs borne by the industry, at least at the proposed rulemaking stage. Staff indicated that industry and market participants historically have not provided compliance costs to the Agency. However, information is being provided to the Commission at this point that does quantify costs. In addition to the rule comments cited throughout this report discussing costs (and we did not cite them all), we would recommend review of the transcript of the Third meeting of the CFTC Technology Advisory Committee presented by the Commission earlier this year. [75] At that meeting, the Commission was presented with a $1.8 billion cost estimate[76] to implement compliance with information technology requirements necessitated under Dodd-Frank, for the top 15 large dealers. We believe the Commission will have a formidable task verifying estimated costs submitted by industry sources, and squaring them with the apparent staff view that the Dodd-Frank rules (or at least the four we reviewed) largely document current practices. We have not attempted to do so here.

We note that the cost-benefit analyses for all four rules lacked any data whatsoever regarding the CFTC's internal costs to implement the Dodd-Frank rules. Inasmuch as the CFTC is projecting these costs in their budget submissions to Congress, we believe it would be feasible to estimate the costs of implementing the each regulation and include it in any cost-benefit analysis. CFTC's opportunity costs might also be considered.

We detect there was some impetus, at least among some staff, to continue to use the same methodology to conduct cost-benefit analyses that had been used since passage of the CFMA when other approaches were suggested by the Office of Chief Economist. Because section 15(a) compliance had never been challenged in the courts, it would appear there was no precedent approving (or disapproving) the Agency's older methodology. Moreover, the joint guidance issued in September 2010 did not require or emphasize adherence to prior methodologies. Instead, the September 2010 guidance would permit a detailed and in-depth qualitative or quantitative approach. We believe it should be followed in a more robust fashion.

In any event, it is clear that the Commission staff viewed section 15(a) compliance to constitute a legal issue more than an economic one, and the views of the Office of General Counsel therefore trumped those expressed by the Office of Chief Economist, at least for the four rules we reviewed. We do not believe this approach enhanced the economic analysis performed under section 15(a) for the four rules.

We believe that as a market regulator, any cost-benefit analysis should take account of price theory economics, which should involve the Chief Economist. While we recognize that an attorney may possess economic insights gained through his or her academic or professional background, the experience of economists who work with such questions on a daily basis should be helpful.

Although we have raised concerns regarding both the methodology and the resulting cost-benefit analyses for each of the four rules, a determination whether the cost benefit analyses

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[75] Third Meeting of the Technology Advisory Committee, Washington, D.C. (March 1, 2011), page 179-available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/tac_030111_transcript.pdf.

[76] "Technology Implications and Costs of Dodd-Frank on Financial Markets," Larry Tabb, Founder & CEO, TABB Group (March 1, 2011), available at: http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/tacpresentation030111_tabb.pdf.

would survive judicial scrutiny is not the object of this investigation. The Commission's performance under section 15(a) of the Commodity Exchange Act has never been challenged; however, in recent years the courts have identified weaknesses in the application of economic analysis to regulatory decisions, resulting in rules being sent back to regulators for further consideration.[77] We would suggest that a more robust examination of costs and benefits should only enhance the Agency's ability to defend its cost-benefit analyses.

We note that the Chairman has initiated a review and revision of the cost-benefit analyses guidance for use with final rulemakings. Work is ongoing, and we recommend that the Office of Chief Economist take on an enhanced or greater role under both the September 2010 guidance and any future methodologies for cost-benefit analyses.

We are encouraged that concerns regarding deadlines and the order of rulemaking raised in the March 11 request from Chairman Lucas and Chairman Conaway appear to be diverted, at least for the moment. The recently proposed plan to adopt the Dodd-Frank rules through a staggered approach may alleviate some concerns. We appreciate the Commission's good intentions in accepting late comments for closed rulemakings.

In closing, we believe that compliance with section 15(a) should not represent a ceiling when it comes to supporting regulation through economic analysis. We are mindful of the adage, "just because something is legal, doesn't make it right." And we wholeheartedly agree that, "[i]n the end, economic analysis is more than about satisfying procedural requirements for regulatory rulemaking."[78]

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[77] See, e.g., *Am. Equity Investment Life Ins. Co. v. S.E.C.*, 613 F.3d 166, 177-178 (D.C. Cir. 2010) ; *Chamber of Commerce of U.S. v. S.E.C.*, 412 F.3d 133, 142-144 (D.C. Cir. 2005).

[78] Testimony of James A. Overdahl, Vice President, National Economic Research Associates, Before the Committee on Financial Services, Subcommittee on Oversight and Investigations, United States House of Representatives March 30, 2011, available at: http://financialservices.house.gov/media/pdf/033011overdahl.pdf.

Exhibit 1

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TO: Rulemaking Teams

FROM: Dan M. Berkovitz
General Counsel

Jim Moser
Acting Chief Economist

RE: *Guidance on and Template for Presenting Cost-Benefit Analyses for Commission Rulemakings*

DATE: September 29, 2010

Section 15(a) of the CEA requires the Commission to consider the costs and benefits before promulgating rules and certain orders.[1] Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.

As the Commission's rulemakings have long recognized, section 15 does not require the Commission to quantify the costs and benefits of an action. However, the Commission cannot consider the costs and benefits of an action unless they are presented either quantitatively or qualitatively. Moreover, as courts have interpreted section 553 of the APA, interested persons must be fairly apprised of the issues involving a proposed rulemaking and must be given an opportunity to comment on the substantive inputs into an agency's decisionmaking.[2]

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[1] 7 U.S.C. 19(a).

[2] See, e.g., American Equity Inv. Life Ins. Co. v. S.E.C., 613 F.3d 166, 177 (D.C. Cir. 2010) (the SEC's consideration of the effect of a rule on competition, which was required by statute, was found to be arbitrary and capricious because a reasoned basis for that conclusion was not disclosed), Chamber of Commerce v. S.E.C., 412 F. 3d 133, 144 (D.C. Cir. 2006) (SEC failed to satisfy its statutory obligation to consider the economic consequences of a rulemaking when it did not apprise itself, or the public and the Congress, of the expected consequences through section 553 notice and comment); and Portland Cement Association v. Ruckelshaus, 486 F.2d 375, 394 (D.C. Cir. 1973) ("[i]t is not consonant with the purpose of a rule-making proceeding to promulgate rules on the basis of inadequate data, or on data that,[in] critical degree, is known only to the agency"), cited by American Radio Relay League v. FCC, 524 F.3d 227, 237 (D.C. Cir. 2008).

In the cost-benefit section of a proposed or interim final rulemaking, an initial analysis of the Commission's views of the costs and benefits of the proposed rule should be presented so that interested parties may submit comments that challenge, defend, or provide additional support for the analysis. A declarative statement of the anticipated effects of the proposed rule should be provided, in addition to requesting that interested parties submit their views on the five cost-benefit considerations enumerated in section 15.

Typically, the costs typically may be presented by describing a counterfactual – what the Commission expects will happen if the rule is not adopted, with reference to previous or anticipated events. The benefits should be provided in declarative form. It is not necessary to present costs and benefits serially for each of the five considerations contained in section 15. Rather, as the costs and benefits are presented, they may be associated with the appropriate considerations in the narrative.

Finally, the requirement to present the costs and benefits of a rulemaking should also assure compliance with the agency's obligations under the Congressional Review Act. Among other things, the Congressional Review Act requires agencies to submit their cost benefit analyses for Congressional review at the time a rule of general applicability is finalized.[3]

GUIDANCE FOR PRESENTING COSTS AND BENEFITS

Costs. The costs discussion in the cost-benefit analysis section of a rulemaking should include a quantitative or qualitative description of the kinds of costs involved, and upon which parties they will be imposed. When presenting costs qualitatively, the costs should be compared to some relevant alternative to the rule (i.e., the benchmark). In many cases, the benchmark would be the status quo regulatory approach. In some contexts, however, an alternative benchmark may be appropriate. If the rulemaking was designed to avoid certain costs associated with an alternative rule that could have been imposed, it should be discussed here as well; essentially comparing the proposed rule to a second benchmark.

> EXAMPLE 1: "The costs of the new capital requirements imposed on FCMs will consist primarily of lower profits to FCMs, as they need to attract more capital to support the same number of positions. These higher capital requirements may also lead FCMs to take smaller proprietary positions, or charge higher fees to customers, potentially reducing the liquidity of some markets.

Benefits. With respect to the benefits associated with a proposed rulemaking, the comparison should be to the same benchmark(s) identified in the discussion of costs, and again the discussion should highlight the kinds of benefits anticipated, and the likely affected parties.

> EXAMPLE 2: "The primary benefit of additional capital requirements is the additional customer protection against FCM failure, especially in the event of another liquidity shortage, such as the one that affected the economy in 2008."

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[3] See 5 U.S.C. 801(a)(1)(B)(i).

For assistance on applying this guidance to specific rulemakings, please contact the Office of Economic Analysis and the Office of General Counsel.

STANDARD TEMPLATE

The following standard template has been prepared to assure consistency across Commission rulemakings:

> Section 15(a) of the CEA[4] requires the Commission to consider the costs and benefits of its actions before issuing a rulemaking under the Act. By its terms, section 15(a) does not require the Commission to quantify the costs and benefits of rule or to determine whether the benefits of the rulemaking outweigh its costs; rather, it requires that the Commission "consider" the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.
>
> Summary of proposed requirements. The proposed rule would [explain briefly the requirements of the rule].
>
> Costs. With respect to costs, the Commission has determined that [draw conclusions about the costs of the rule, associating the appropriate cost-benefit categories either directly or by implication].
>
> Benefits. With respect to benefits, the Commission has determined that [draw conclusions about the benefits of the rule, associating the appropriate cost-benefit categories either directly or by implication].
>
> Public Comment. The Commission invites public comment on its cost-benefit considerations. Commenters are also are invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters.

[4] 7 U.S.C. 19(a).