United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510–6250

August 29, 2011

Filed via email at rule-comments@sec.gov

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

RE: **File Number S7-25-11; Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants**

Dear Ms. Murphy:

The purpose of this letter is to express support for and suggest enhancements to the proposed rule,[1] issued pursuant to Section 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), outlining minimum business conduct standards for security-based swap dealers and major security-based swap participants, known collectively as "SBS entities." Strong business conduct standards, including in particular those related to suitable recommendations and fair and balanced communications, are essential to restore integrity and confidence in U.S. financial markets, especially after the widespread abusive conduct that contributed to the recent financial crisis.

The efforts of the Securities and Exchange Commission (SEC) to impose business conduct standards on SBS entities are parallel to, and should be closely coordinated with, the efforts of the Commodity Futures Trading Commission (CFTC) to impose analogous standards for the swap dealers and major swap participants overseen by that agency.[2] As a general matter, the SEC's proposed rule should be modified to more closely align with those of the CFTC.[3] Similar rules will substantively enhance investor and market protections, as well as reduce redundancies, regulatory burdens, and costs for market participants.

More specifically, among other measures, it is respectfully recommended that the SEC enhance the proposed rule by:

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[1] 76 Fed. Reg. 42396 (Jul. 18, 2011).

[2] Dodd-Frank Act § 731.

[3] *See, e.g.*,75 Fed. Reg. 71397 (Nov. 23, 2010), 75 Fed. Reg. 81519 (Dec. 28, 2010), and 76 Fed. Reg. 6715 (Feb. 8, 2011); Dodd-Frank Act § 712.

1) strengthening the disclosures related to material risks and characteristics by requiring SBS entities to disclose any material risk related to the source of a security-based swap's assets and any negative view by the SBS entity itself of the assets' riskiness;

2) ensuring that disclosures related to material incentives and conflicts of interest are coordinated with Sections 619 and 621 of the Dodd-Frank Act prohibiting certain conflicts of interest, and include in the disclosures to investors of any otherwise hidden profits or returns that the SBS entity expects to make from a security-based swap, related agreement or arrangement, or related hedging or trading activity;

3) improving the disclosure provisions related to daily marks for uncleared swaps by requiring the use of third party quotations whenever possible, allowing use of the midpoint between an SBS entity's bid and offer prices as the daily mark only when the SBS entity's internal book value falls within the same price range, and requiring disclosure to investors upon request the data sources, methodology, and assumptions used to prepare the daily marks; and

4) using its broad authority under Section 15F(h)(3)(D) of the Exchange Act to promote transparency and minimize risk by requiring periodic portfolio reconciliation and portfolio compression.[4]

Enhancements to Disclosure Requirements

Pursuant to the express language of the statute, the SEC has proposed requiring disclosures by SBS entities of the material risks and characteristics of a security-based swap, material incentives or conflicts of interest in connection with a security-based swap, and the daily marks assigned to security-based swaps.[5]

Material Risks and Characteristics. The first set of disclosures involves material risks and characteristics of security-based swaps being marketed to investors. The proposed rule should be strengthened by requiring SBS entities to disclose material risks and characteristics of, not just of the security-based swap itself, but also with respect to any reference securities, indices, or other assets. This disclosure is especially important when the SBS references unique pools of assets arranged by the SBS entity, as opposed to functioning as a "plain-vanilla" swap.

Over the past two years, the Permanent Subcommittee on Investigations, which I chair, has conducted an extensive investigation into key causes of the financial crisis. One Subcommittee case study examined the role of investment banks in the financial crisis, exploring how Goldman Sachs and Deutsch Bank structured, marketed, and sold high risk, poor quality mortgage products to investors. The Subcommittee's investigation identified several specific instances in which Goldman failed to disclose material risks and characteristics of its financial products to investors, failures that are addressed only in part by the proposed rulemaking.

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[4] *See* 75 Fed. Reg. 81519 (Dec. 28, 2010).

[5] Securities Exchange Act of 1934, § 15F (h)(3)(B).

For example, in the fall of 2006, Goldman assembled Hudson Mezzanine 2006-1 ("Hudson"), a $2 billion synthetic CDO that referenced subprime residential mortgage backed securities (RMBS). At the time, senior Goldman executives felt that declines in the ABX index, an index of subprime mortgages securities, were eminent. Rather than trade away its unwanted ABX assets using index swaps, Goldman decided the most efficient method to reduce its exposure to the ABX index was to assemble the Hudson CDO. The assets Goldman selected for Hudson consisted of $1.2 billion in ABX assets from its own balance sheet, and another $800 million in outright shorts of subprime RMBS. These assets were placed on the balance sheet of an offshore shell corporation via a credit default swap (CDS), and then marketed to investors. Although Goldman provided vague and generalized risk factors, it failed to inform investors that the CDO was specifically designed to remove risky underlying assets from Goldman's balance sheet and to produce profits for the firm from shorting the referenced RMBS assets. Goldman's clients ended up losing nearly $1.7 billion from their investments in Hudson.

In another example in 2007, Goldman assembled Anderson Mezzanine Funding 2007-1 ("Anderson"), a $500 million synthetic CDO constructed using CDS contracts referencing subprime RMBS. The majority of the referenced assets in Anderson had been issued by subprime lenders which were known to Goldman for issuing poor quality loans. The largest single issuer was New Century, which at that time was being scrutinized by Goldman for its poor quality loans. During the period in which Goldman assembled and sold the Anderson securities, Goldman had a strongly negative view of the mortgage market and was working intensively to remove mortgage-related assets from its balance sheet, including from New Century. A senior Goldman executive had considered liquidating the Anderson CDO due to the falling value of its assets, but instead decided to market the Anderson CDO to investors. In summary, at the time Anderson was issued, Goldman had a negative outlook of the entire mortgage market, a negative view of Anderson's largest issuer, New Century, and a negative view of the specific assets in Anderson. None of these risks was disclosed to investors. In fact, when an investor raised concerns about the New Century loans referenced in the CDO, Goldman worked affirmatively to dispel those concerns. Ultimately, Anderson investors lost virtually their entire investments.

To ensure that SBS entities provide material information to investors, the proposed rule should specifically require them to disclose all material risks and characteristics of not only the security-based swap, but also of any assets referenced by that swap. Requiring disclosures related to the underlying assets is particularly critical for security-based swaps in which the underlying assets have been selected and pooled by the SBS entity, as was the case in Hudson. Thedisclosures should include material risk information related to the source of the swap's assets and any negative view by the SBS entity itself of the assets' riskiness – thus preventing situations like Hudson and Anderson wherein Goldman bet against its own clients and hid its own negative view of the market from investors.

The required risk disclosures should be made to all counterparties, and opting out should not be permitted. In particular, in instances such as Hudson and Anderson, where the swaps took place between the SBS entity and a Cayman Islands shell corporation, risk disclosures should be made by both the SBS entity and the shell corporation to all investors. Furthermore, SBS entities should not be allowed to avoid providing material risk disclosures to a "qualified institutional buyer," since even sophisticated investors were misled during the financial crisis about the nature of the securities they purchased.

Material Incentives and Conflicts of Interest. Pursuant to the express language of the statute, the proposed rule also requires SBS entities to disclose material incentives or conflicts of interest in connection with a security-based swap. The proposed rule defines "incentives" as "any other financial arrangements pursuant to which an SBS entity may have an incentive to encourage the counterparty to enter into the transaction." It excludes from the definition, however, "any profit or return that the SBS entity would expect to earn from the security-based swap itself, or from any related hedging or trading activities of the SBS entity." This exclusion is ill advised and could enable SBS entities to hide important information from investors, including potential profits or loss avoidance gained because of a hidden adverse interest, that a reasonable investor would want to know prior to making an investment decision.

The Subcommittee's case study into the role of investment banks in the financial crisis illustrates a number of financial arrangements involving hidden profits or returns for an SBS entity about which a reasonable investor would want to be informed.

In September 2006, for example, Goldman executives realized that the firm had significant long exposure to mortgage-related securities. To reduce the firm's exposure, its traders began to sell or transfer to others the risk of loss from its mortgage-related positions, including by using security-based swaps to create and sell interests in synthetic CDOs designed or expected to produce profits for the firm when the CDOs declined in value.

The Hudson CDO, mentioned above, was one of those synthetic CDOs. Goldman structured the CDO itself, transferring $1.2 billion of its own risk to investors while telling potential investors that Hudson was "not a balance sheet CDO" and was "sourced from the Street." Goldman held 100 percent of the short side of the CDO, meaning that in the event of widespread default on the referenced assets, the Hudson shell corporation set up by Goldman as the legal issuer of the securities would stop making payments to investors and start making payments to Goldman using investors' funds. The CDO represented a zero-sum transaction: either Goldman or the investors made money, but not both. Thus, Goldman's position was diametrically opposed to that of its own clients.

Goldman then marketed and sold this CDO to potential investors, telling them that it had "aligned" its interests with investors and mentioning that it held a $6 million equity share while simultaneously failing to disclose that it was shorting all $2 billion of Hudson's assets. The marketing materials contained a section entitled "Certain Conflicts of Interest" that stated that "GSI [the Goldman affiliate involved in Hudson] and/or any of its affiliates may invest and/or deal" in securities or other interests in the assets underlying Hudson, and "may invest and/or deal" in CDS contracts that are "linked to" the Hudson investments. By the time these materials were circulated, however, Goldman had already decided to keep 100 percent of Hudson's short side. Thus, the marketing material misrepresented Goldman's investment plans, and the extent of Goldman's adverse interests in Hudson was not known to the investors that it solicited. Ultimately, the Hudson CDO enabled Goldman to earn a gross profit of $1.7 billion at the direct expense of its clients.

Similarly, Goldman retained 40 percent of the short side of the Anderson CDO, a CDO that Goldman expected to perform poorly. Anderson produced a $131 million gain for Goldman at the direct expense of the investors to whom it had sold the Anderson securities. It also held 36 percent of the short side of Timberwolf I CDO ("Timberwolf"), which produced about $330 million in revenues for the firm at the direct expense of the clients who invested in that CDO. In neither case did Goldman disclose its short position to investors, nor did Goldman ever disclose to any of its investors that it had built a large net short position betting that RMBS securities similar to the ones referenced in Hudson, Anderson, and Timberwolf would lose value.

Goldman's short positions on its CDOs encouraged other self-dealing actions on the part of Goldman. For example, the firm exploited a conflict of interest resulting from serving as the "liquidation agent" in the Hudson CDO. As liquidation agent, Goldman promised to liquidate on a nondiscretionary basis any Hudson asset determined to be a "credit risk." Instead, despite urgent requests from Hudson investors, Goldman delayed liquidating the assets for months, while maximizing its profits from its short position. In the Timberwolf CDO, Goldman used its role as the collateral security agent to protect its own short interests, to the detriment of investors.

Still another conflict of interest is demonstrated in the case of the Abacus 2007-AC1 CDO ("Abacus"). Goldman created Abacus in partnership with a hedge fund, Paulson & Co., which Goldman knew held strong negative views of the residential mortgage market, and the CDO was structured to enable Paulson to short multiple RMBS securities. As part of the arrangement, Paulson agreed to pay Goldman a higher fee if Goldman could provide Paulson with CDS contracts requiring premium payments below a certain level. Lower premiums for Paulson translated into lower premium payments to the CDO, directly reducing the amount of cash available to long investors. In marketing and selling Abacus to long investors, Goldman not only failed to disclose the key role that the hedge fund played in the asset selection process to the detriment of potential investors, it also failed to disclose how its own economic interest was aligned with Paulson – and against the investors to whom it was selling the securities – through the side arrangement for lower premium payments.

The Subcommittee's investigation demonstrates that problematic conflicts of interest arise not only from "financial arrangements pursuant to which an SBS entity may have an incentive to encourage the counterparty to enter into the transaction," as was the case in Abacus. Problematic conflicts of interest also arise from hidden profits that an SBS entity has arranged to earn from the swap itself, including profits from related management, hedging, or trading activities of the SBS entity, as was the case in Hudson, Anderson, and Timberwolf. Thus, the SEC should expand the definition of "incentives" to include profits or returns that the SBS entity expects to make from any undisclosed adverse interest in the swap, a related agreement or arrangement, or a related hedging or trading activity.

In addition, the proposed material incentives and conflicts of interest disclosure requirements need to be coordinated and work in conjunction with the conflict of interest prohibitions in Section 621 of the Dodd-Frank Act related to asset-backed securitizations, as well as the limitations on permitted activities outlined in Section 619.[6] It is critical that the proposed rule make it clear that the conflict of interest prohibitions in those sections cannot be circumvented or somehow nullified through application of the disclosure requirements in the business conduct standards adopted pursuant to Section 764.

Daily Marks. The Dodd-Frank Act also amends the Exchange Act to direct the SEC to require SBS entities to disclose the daily marks assigned to security-based swaps.[7] The SEC has interpreted the statute to require the disclosure of the end-of-day settlement price from the appropriate clearing organization for cleared security-based swaps, and the midpoint between the bid and offer prices, or the calculated equivalent thereof, for uncleared swaps. While using the settlement price of an appropriate clearing organization as the daily mark for cleared swaps may be a sensible approach, using an SBS entity's own bid and offer prices to determine the daily marks for uncleared swaps could, without further restrictions, invite abuses.

The Subcommittee's case study found ample evidence of marking abuses by Goldman in connection with security-based swaps it fashioned and sold to investors. Those abuses included pricing the swaps higher than its internal valuations, refusing to provide investors with its pricing methodology and scenarios, and presenting investors with bid-offer spreads that had little relation to the firm's own internal valuations.

The Timberwolf CDO, discussed above, provides a prime example of these problems. Goldman sold Timberwolf security-based swaps to clients at a much higher price than Goldman knew they were worth, marked the value down substantially days or weeks after the sale, and refused to provide its pricing methodologies or scenarios to investors who requested them.

Timberwolf was issued in March 2007, when concerns about declining mortgage assets caused Goldman to rush Timberwolf to market. By May 2007, Goldman believed the value of the assets referenced in Timberwolf had fallen significantly and conducted an extensive revaluation of that and other CDOs. The results of this valuation project indicated that the Timberwolf prices should be dramatically lower. However, Goldman did not provide notice to clients, either directly or through the Timberwolf shell corporation, that the SBS underlying Timberwolf had lost significant value. Rather, Goldman continued to market at inflated prices. For example, on May 25, 2007, Goldman internally marked down the value of AAA- rated Timberwolf A2 securities to 80. However, Goldman sold Timberwolf to clients at prices of 87 on May 24, 83.90 on May 30, and 84.50 on June 11.

Goldman's sale of Timberwolf security-based swaps at inflated prices also created the potential for rapid markdowns after an SBS was sold. For example, on June 13, 2007, Goldman sold a client, Basis Capital, AA-rated Timberwolf securities via CDS at a price of 77.3, despite an internal mark of 65. It also sold Basis Capital AAA-rated Timberwolf securities via CDS at a

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[6] Section 621 prohibits firms that issue asset-backed securities from engaging "in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity." Section 619 generally restricts proprietary trading and relationships with certain types of funds, subject to certain enumerated exceptions, but also disallows covered firms from engaging in activities that would "involve or result in a material conflict of interest ... between the [firm] and its clients, customers, or counterparties."

[7] Exchange Act § 15F(h)(3)(B)(iii).

mark of 84.3 despite an internal mark of 80. One month later, on July 12, Goldman marked down the value of both the Timberwolf AAA and AA securities to 65 and 60, respectively. On July 16, Goldman marked them down further to 55 and 45, numbers that matched Goldman's internal valuations from July 12. By the end of July, Basis Capital liquidated its assets, and Goldman bought back its Timberwolf holdings at prices of 30 and 25.

Although Goldman executives have suggested that the reason for the differences between the selling prices and internal valuations of their CDO securities was the bid-offer spread, there appears to have been little to no relationship between the securities' internal valuations and the bid and offer prices quoted to clients. For example, at the end of June 2007, Goldman provided Timberwolf investor Moneygram with an offer price of 86 for Timberwolf A2 securities and a bid price of 83. Goldman's internal valuation of the same securities was 75. Furthermore, Goldman executives defended their marks by noting they stood willing to buy or sell SBS at their marks. While the mortgage markets were in turmoil in the summer of 2007, however, Goldman lowered the size of its actionable bid to $1 million, a size far too small to ensure accurate marking.

Throughout the period in which it sold Timberwolf, Goldman consistently refused to provide investors with its pricing methodology, data scenarios, or specific marks for the securities it marketed. An internal Goldman email from management instructed its sales personnel as follows:

> [U]nder no circumstances are we going to be able to provide materials specific to Timberwolf ... or even use the word 'mark' in written materials. ... Everything will be described in general terms, and if what we provide is too vague or general, the medium for further clarification must be oral, not written.

Investors often asked for pricing and valuing information, seeking additional information to understand the daily marks assigned to their swap holdings. An email from a Basis Capital investor, for example, asked: "How many times do we have to request data points and scenarios by email. ... I am getting weary of continually hearing about transparency and yet an obvious avoidance of 'putting things to paper.'" Another Timberwolf investor, Hungkuk Life, received asset reports from Goldman with the pricing and valuing information removed. Additionally, Goldman did not inform its investors when its pricing methodology changed, as it did in during its CDO valuation project in May 2007.

One key measure to protect against abusive marks would be to require SBS entities to disclose to any investor upon request the data sources, methodology, and assumptions used to prepare daily marks. Those data sources, methodology, and assumptions should constitute a "complete and independently verifiable methodology for valuing each [security-based] swap entered into between the parties".[8] To the extent that those sources, methodology, or assumptions change in a material way, become unreliable, or become unavailable, SBS entities should be required to disclose those developments and any resulting changes to the valuations.

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[8] *See* 76 Fed. Reg. 6715, 6719 (Feb. 8, 2011).

The Subcommittee's research also suggests that using the midpoint of the bid-offer spread may be an appropriate daily mark for uncleared swaps only so long as the relevant SBS entity's internal book value also falls within that range. The rules should be strengthened to impose that requirement on SBS entities producing daily marks. To further protect against abusive pricing, the SEC should require SBS entities to use third-party market quotations when calculating an uncleared swap's midmarket value, whenever possible. In addition, the SEC should consider requiring the SBS entity to provide clients with actionable quotes or prices at which the SBS entity would terminate the swap or allow the client to buy more. Furthermore, the SEC should consider requiring SBS entities to provide actionable quotes at a significant size as a means to ensure accuracy.

Portfolio Reconciliation and Compression

To further strengthen the rule and bring it into closer alignment with the approach taken by the CFTC, the SEC should use its broad authority under Section 15F(h)(3)(D) to require SBS entities to engage in portfolio reconciliation and compression, which would increase transparency, promote market integrity, reduce risk, and promote regulatory consistency across related products.[9]

As the CFTC noted in its analogous proposed rules:

> Through portfolio reconciliation, counterparties are able to resolve any discrepancies or disputes as early as possible and arrive at an understanding of their overall risk exposure to one another. Portfolio compression allows for a reduction in outstanding trade count and outstanding gross notional value by replacing redundant trades with a smaller number of trades and reduced gross notional value. This process reduces operational risk and increases operational efficiency because there are fewer trades to maintain, and results in a more accurate expression of market size.[10]

Portfolio reconciliation, which could be performed on a bilateral basis or by a qualified third party, should be performed on a regular basis, with the frequency determined in large part by the materiality and size of the SBS entity's security-based swap portfolio. Collectively, portfolio reconciliation and compression would improve both counterparties' abilities to indentify and manage their security-based swap-related risk exposures, and should be adopted.

Duty to Make Suitable Recommendations

Pursuant to the statutory text in Section 764 of the Dodd-Frank Act, the proposed rule would also impose a duty on SBS entities to make suitable recommendations when marketing SBS to clients. The proposed rule would require an SBS dealer to "have a reasonable basis to believe: (i) Based on reasonable diligence, that the recommended security-based swap or trading

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[9] *See* 75 Fed. Reg. at 81520.

[10] Id.~~75 Fed. Reg. at 81520.~~

strategy involving a security-based swap is suitable for at least some counterparties; and (ii) that a recommended security-based swap or trading strategy involving a security-based swap is suitable for the counterparty."[11]

To establish a reasonable basis for a recommendation, an SBS dealer would need to have or obtain relevant information regarding the counterparty, including the counterparty's investment profile, trading objectives, and its ability to absorb potential losses associated with the recommended security-based swap or trading strategy. In addition, under the proposed rule, an SBS dealer that makes a "recommendation" to a counterparty must have a reasonable basis for believing that the recommended security-based swap or trading strategy involving security-based swaps is suitable for at least some counterparties. It could no longer recommend security-based swaps that the SBS dealer expected to lose value for the investors who purchased them.

The need for this suitability requirement is strongly supported by the Subcommittee's work, which uncovered significant evidence of unsuitable recommendations made by investment banks, essentially urging investors to buy security-based swaps that the investment bank expected or knew were designed to lose value.

Goldman, for example, consistently constructed, marketed, and sold security-based swaps referencing pools of subprime RMBS that Goldman knew were of poor quality, including RMBS containing loans issued by lenders known to Goldman for issuing poorly performing mortgages. Additionally, Goldman specifically marketed via CDS arrangements Timberwolf securities which it knew were falling sharply in value to non-traditional buyers and clients outside of the United States. In the case of Basis Capital, Goldman actively pushed sales to a hedge fund that it had good reason to believe could not absorb the expected losses. Goldman also knew Basis Capital was traditionally an equity investor, and had little experience with the synthetic CDOs being marketed to the fund. Less than two months after entering into a $100 million swap involving Timberwolf securities with Goldman, Basis Capital was forced to liquidate its hedge fund holdings, due to the losses it suffered from that purchase.

Goldman also sold securities to investors that the bank itself was betting would fail. For example, Goldman held 100 percent of the short side in the Hudson CDO via CDS, and had structured the transaction specifically to remove unwanted risk from its balance sheet. Goldman held 40 percent of the short side of the Anderson CDO, the largest short position of any party to that transaction. In the Abacus transaction, Goldman had allowed the referenced assets to be influenced by the Paulson hedge fund, which had a known, negative view of the residential mortgage market, held 100 percent of the short side of the CDO, and had a side arrangement with Goldman to obtain lower premium payments. In all three cases, Goldman sold the security-based swaps to its clients with the expectation that the long side of the swaps would lose value.

An SBS dealer should not only understand the swap or trading strategy that it is recommending to investors, it should also have reason to believe that the recommendation is suitable for a specific investor, that the swap is not designed or expected to lose value to the detriment of that investor, and that the investor is able to bear potential losses. The proposed

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[11] 76 Fed. Reg. at 42440.

rule may want to state plainly that, under its provisions, SBS dealers cannot recommend to investors financial products that the dealers believe will fail. Additionally, the proposed rule should consider requiring that an SBS dealer making recommendations regarding a certain product or type of product have background in understanding that product.

The proposed rule currently allows SBS dealers to fulfill their suitability requirement with respect to any specific counterparty if they: "(1) reasonably determine that the counterparty (or its agent) is capable of independently evaluating the investment risks related to the security-based swap or trading strategy; (2) the counterparty (or its agent) affirmatively represents that it is exercising its independent judgment in evaluating the recommendation; and (3) the SBS Dealer discloses to the counterparty that it is acting in its capacity as a counterparty and is not undertaking to assess the suitability of the security-based swap or trading strategy."[12] The proposed rule requires such institutional-specific suitability determinations to be supported by representations documented in writing.[13]

The SEC should be wary of these institutional-level suitability determinations which could quickly become outdated, or simply ignored, boiler-plate language that is inappropriate for the counterparty to which it is directed. The SEC should consider requiring firms to conduct routine audits to ensure that these institutional-level suitability determinations are not over-utilized, that they are appropriate for the particular counterparties involved, and that the appropriate written documentation was provided and signed in applicable transactions. As part of that audit process, and to prevent inaccurate determinations, firms should be required to test, perhaps on an annual basis, whether the counterparties continue to have the personnel and expertise needed to conduct independent evaluations of the SBS products being marketed.

Without these basic investor protections, to safeguard against the marketing by SBS dealers of unsuitable SBS products that are expected or designed to fail, investor confidence in U.S. financial markets as fair, open, and efficient will not be restored.

Duty to Communicate in a Fair and Balanced Manner

Consistent with the express text of the statute,[14] the proposed rule would require SBS entities to communicate with their counterparties in a fair and balanced manner based upon principles of fair dealing and good faith.[15] This provision, which tracks longstanding principles of exchanges and other self-regulatory organizations, is also strongly supported by the Subcommittee's work, which found many instances of misleading and inaccurate communications by SBS dealers to investors.

The marketing materials associated with the Hudson CDO, for example, stated that Hudson was "not a balance sheet CDO" and was "sourced from the Street," even though Goldman itself had structured and priced the CDO, using it to transfer $1.2 billion of risk from

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[12] 76 Fed. Reg. at 42440.
[13] 76 Fed. Reg. at 42440.
[14] Section 15F(h)(3)(C) of the Securities Exchange Act of 1934.
[15] 76 Fed. Reg. at 42440.

its own books to investors. The marketing materials also contained a section entitled "Certain Conflicts of Interest" that stated that "GSI [Goldman Sachs] and/or any of its affiliates may invest and/or deal" in securities or other interests in the assets underlying Hudson, and "may invest and/or deal" in CDS contracts that are "linked to" the Hudson investments. However, by the time those materials were circulated, Goldman had already decided to keep 100 percent of Hudson's short side. Thus, the marketing materials misrepresented Goldman's investment plans.

Additionally, Goldman told Hudson investors that it had "aligned" its interests with them and held a $6 million equity share of the CDO, without also disclosing that it was shorting all $2 billion of Hudson's assets. Similarly, when marketing the Anderson CDO, Goldman informed investors that it would be holding up to 50% of the CDO's equity tranche – worth about $21 million – without mentioning that it would also be holding 40% of the short side of Anderson – worth about $135 million. Goldman also sold Timberwolf securities via CDS arrangements to investors at inflated values, withholding its internal analysis that the Timberwolf securities were dropping sharply in value. In addition, Goldman deliberately avoided specificity in its written materials, instructing its Timberwolf sales personnel that "[e]verything will be described in general terms, and if what we provide is too vague or general, the medium for further clarification must be oral, not written."

In order to be fair and balanced, communications from an SBS entity must inform investors of both the potential rewards and risks of their investments, and the entity's own involvement and interests in the investments, in specific terms. All material adverse interests must be disclosed and communicated. The proposed rules should also make it clear that it is not enough to inform a customer that the SBS entity "may" have an adverse interest if that adverse interest already exists.[16]

Thank you for the opportunity to comment on the proposed rule.

Sincerely,

Carl Levin

Carl Levin
Chairman
Permanent Subcommittee on Investigations

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[16] *SEC v. Czuczko*, Case No. CV06-4792 (USDC CD Calif.), Order Granting Plaintiff's Unopposed Motion for Summary Judgment (Dec. 5, 2007) (finding defendant made a material misstatement to potential investors when he disclosed that officers, directors, employees and members of their families "may" trade in the stocks recommended on his website, without disclosing that he, his father, and business partner were trading in those stocks and had an interest in them).