July 23, 2019

By Electronic Submission

Securities and Exchange Commission
Secretary
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements (File Number S7–07–19)

Ladies and gentlemen,

Better Markets, Inc.[1] ("Better Markets") appreciates the opportunity to provide comments on the Securities and Exchange Commission's ("SEC") proposal to implement guidance and substantial revisions to regulations governing the cross-border application of certain security-based swap ("SB-Swap") requirements ("Proposal").[2] The proposed guidance is fatally flawed legally in critical respects and conflicts with the plain language and explicit statutory objectives of the Securities Exchange Act of 1934 ("Exchange Act").[3] In addition, the proposal departs from longstanding precedent concerning the SEC's jurisdiction over territorial activities, in the process facilitating evasion or avoidance of critical pillars of the SB-Swap framework.

As concerning as its content, the Proposal ***repeatedly*** bases proposed revisions on comments made in letters submitted entirely outside of the current rulemaking by two of the largest trade associations and lobbying organizations for the financial industry: the Securities Industry and Financial Markets Association and the Institute of International Bankers.[4] The proposed

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[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] See Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206 (May 24, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-05-24/pdf/2019-10016.pdf.

[3] 15 U.S.C. § 78a et seq.

[4] The SEC cites to letters submitted outside of the current rulemaking record by these two financial industry lobbying organizations **39 times**, a clear indication of the interests benefited by the substantial revisions in the Proposal. The SEC cites to a

policy judgments in the Proposal would be unlawful and ill-advised regardless of their source. However, substantially revising existing regulations—long before compliance has even been required—and doing so on the bases of wish lists from large banking interests seeking to protect their profits in and domination of the SB-Swaps markets is indefensible and patently contrary to the SEC's public interest mandate. The SEC's proposed rulemaking therefore must be promptly withdrawn or dramatically improved to avoid the potential for years of post-rulemaking litigation, which can only increase regulatory uncertainty in the SB-Swap markets and render effective SEC oversight all but impossible.

I. Title VII of the Dodd-Frank Act was adopted in the aftermath of the 2008 financial crisis to address numerous risks arising from dealer-dominated, over-the-counter security-based swaps markets.

Just ten short years ago, the worst financial crisis since the Great Depression again proved that market discipline alone is grossly insufficient to promote competitive, transparent, properly risk managed, fair, and safe and sound derivatives markets. The ultimate consequence was economic devastation for tens of millions of Americans, many of whom have suffered and are still suffering from un- and under-employment,[5] low wages,[6] excessive student loans,[7] damaged credit

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mere nine other letters in the proposal *total*, even though numerous comment letters have squarely addressed issues raised in the Proposal (and in the same rulemaking record in which the industry's comment letters were submitted). This clear bias for—and prioritization of—the industry's views for what the SEC's regulatory policy should be raises fundamental questions about the present rulemaking and significant doubts about its consistency with the Administrative Procedure Act ("APA").

[5] In the immediate aftermath of the 2008 financial crisis, the U6 total unemployment and underemployment rate published by the U.S. Bureau of Labor Statistics reached a peak of 17.1%, which was more than twice the highest measure in 2007. See U.S. Bureau of Labor Statistics, Total unemployed, plus all marginally attached workers plus total employed part time for economic reasons [U6RATE], retrieved from FRED, Federal Reserve Bank of St. Louis (March 15, 2019), available at https://fred.stlouisfed.org/series/U6RATE. Unemployment and underemployment rates increased dramatically during and after the 2008 financial crisis and remained high by historical standards well into 2010, when they began a decline. Id. However, the U6 rate did not return to 2007 levels for ten years, only in 2017, and even then, with substantial geographical variation. Id. The headline U1 unemployment rate followed a similar trend, reaching its peak in 2010 and declining to 2007 levels for the first time in 2017 (although those top line numbers did not capture the wage depression and ongoing massive under-employment suffered by tens of millions of Americans). See U.S. Bureau of Labor Statistics, Persons Unemployed 15 weeks or longer, as a percent of the civilian labor force [U1RATE], retrieved from FRED, Federal Reserve Bank of St. Louis (March 15, 2019), available at https://fred.stlouisfed.org/series/U1RATE. See attached Appendix A.

[6] Median household income dropped significantly in the aftermath of the 2008 financial crisis, reaching its low in 2012 before beginning a return to pre-crisis levels over the next five years. See U.S. Census Bureau: U.S. Department of Commerce, Economics and Statistics Administration, Household Income: 2017 (ACSBR/17-01), G. Guzman (Sept. 2018), available at https://www.census.gov/content/dam/Census/library/publications/2018/acs/acsbr17-01.pdf. Notably, it took almost a full decade after the 2008 financial crisis for U.S. households to again achieve 2007 median income levels, again with substantial geographic variation. Id. See also U.S. Census Bureau: U.S. Department of Commerce, Economics and Statistics Administration, Income and Poverty in the United States: 2017, Current Population Reports (P60-263), pg. 11, Figure 4, K. Fontenot, J. Semega, and M. Kollar (Sept. 2018) (noting that, in the aftermath of the 2008 financial crisis, the number of families in poverty reached its highest recorded level since 1959), available at https://www.census.gov/content/dam/Census/library/publications/2018/demo/p60- 263.pdf.

[7] Total outstanding student loan debt, accumulated significantly due to diminished employment prospects in the aftermath of the 2008 financial crisis, reached an aggregate balance of $1.46 trillion in 2018; serious delinquencies on student loan debt remain well above pre-crisis levels. See Federal Reserve Bank of New York, Research and Statistics Group, Quarterly Report on Household Debt and Credit: 2018: Q4 (Released Feb. 2019), available at https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/hhdc_2018q4.pdf.

records,[8] foreclosures and lost equity in their homes,[9] and more.[10] The incalculable harm caused by the 2008 financial crisis—exacerbated by the over-the-counter ("OTC") derivatives market structure—has required the longest continuous expansion in U.S. economic history for many families to even begin an incremental recovery from these effects.[11] Many families still have not recovered. One recent Federal Reserve staff study concluded, for example, that the vast majority of American families remain economically worse off today than they were in 2007; it also concluded that measures of wealth inequality have considerably worsened.[12]

In short, the deep and long-lasting wreckage caused by the 2008 financial crisis has proven that (other than war) nothing devastates a country more than the economic ruin that follows financial crises.

In the midst of this anomalous period of economic expansion, it is worth pausing to consider the tendency for most people—including, of course, executives in the financial industry—to "forget" even the very recent past and to yield to pressures from shareholders, management, and

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[8] Total delinquent balances on household debt, including severely derogatory balances, dramatically increased in the aftermath of the 2008 financial crisis, reaching a peak in 2009 and remaining well above 2006 levels to date. Id. at 11.

[9] By 2011, Zillow data indicated that more than 30% of outstanding mortgages were in negative equity, meaning mortgage balances were higher than expected sales prices on the underlying homes. That figure remained above 15% well into 2015. See Appendix C. See also, e.g., Federal Housing Finance Agency, U.S. House Price Index Report—4Q 2018, National Statistics Appendix, Pgs. 7-12 (Feb. 2, 2019), available at https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/2018Q4_HPI.pdf (measuring significant declines in the "FHFA House Price Index History for U.S." during and immediately after the 2008 financial crisis). See also J. Gallin, R. Malloy, E. Nielsen, P. Smith, and K. Sommer, Federal Reserve Board, Divisions of Research & Statistics and Monetary Affairs, Measuring Aggregate Housing Wealth: New Insights from an Automated Valuation Model (2018-064), Staff Working Papers in the Finance and Economics Discussion Series, 30-31, Fig. 3: Aggregate Own-Use Housing Wealth (Aug. 2018), available at https://www.federalreserve.gov/econres/feds/files/2018064pap.pdf (comparing the dramatic loss of housing wealth across three measures and noting that "the ACS measure fell by 14 percent from peak to trough, the Financial Accounts fell by 29 percent from peak to trough, and the AVM measure splits the difference between these two, falling by 21 percent from peak to trough").

[10] The 2008 financial crisis had immense personal and social consequences, potentially influencing suicide, divorce, child neglect, substance abuse, and other rates. These human tragedies are too often overlooked when considering the impacts of financial crises, and although they can be difficult to measure, they are very real. See, e.g., Child neglect linked to parental unemployment (Nov. 2017), available at http://www.ox.ac.uk/news/2017-11-02-child-neglect-linked-parental-unemployment (finding that the crisis-linked unemployment measurably increased rates of child neglect); see also, e.g., P. Agrawal, D. Waggle, D. Sandweiss, Suicides as a response to adverse market sentiment (1980-2016) (Nov. 2, 2017), available at https://journals.plos.org/plosone/article?id=10.1371/journal.pone.0186913 (noting the increase in suicides as a result of the Great Recession of 2008 and finding a correlation between changes in gross domestic product as a result of such financial crises and certain stress-induced behavioral changes).

[11] See U.S. Bureau of Labor Statistics, Gross Domestic Product [GDP], retrieved from FRED, Federal Reserve Bank of St. Louis (March 15, 2019), available at https://fred.stlouisfed.org/series/GDP/. **The U.S. has now entered its longest continuous economic expansion without an intervening recession in modern U.S. history.**

[12] L. Dettling, J. Hsu, and E. Llanes, A Wealthless Recovery? Asset Ownership and the Uneven Recovery from the Great Recession (Sept. 13, 2018), available at https://www.federalreserve.gov/econres/notes/feds-notes/asset-ownership-and-the-uneven-recovery-from-the-great-recession-20180913.htm (finding that data from the Federal Reserve Board's triennial Survey of Consumer Finances "suggests the wealth gaps uncovered . . . may persist despite the continued economic recovery, as those families [in the bottom 90% of the wealth distribution] will not experience wealth gains from the rise in housing and stock prices . . .").

others to "get up and dance while the music is playing."[13] But this time is not different.[14] The music will stop, inevitably exposing undetected, misunderstood, or ignored imbalances and risks within the financial system. The SEC's primary responsibility must be to anticipate that inevitability and limit the damage that will be inflicted on those participating in and depending on the financial markets when it does, including working Americans that inevitably bear the consequences.

The SEC's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[15] is a key means for protecting the American public, the U.S. financial markets, and the public interest. Unfortunately, the SEC has been in violation of its statutory mandate to properly implement derivatives reforms in Title VII of the Dodd-Frank Act since July 2011.[16] More than seven years after joint final rules and almost a decade after passage of the Dodd-Frank Act, the SEC has not yet required any security-based swap dealer ("SB-SD") to register with the commission, much less required compliance with the full panoply of market integrity and systemic risk protections mandated by Congress.[17]

This is an eight-year dereliction of duty (and still counting). **The SEC's apparent determination to ignore a congressional mandate across multiple administrations—and so flagrantly—is remarkable and unprecedented.** It is especially concerning, however, given the direct contribution of SB-Swaps markets—more than other derivatives markets subject to Title

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[13] This is a reference to a statement made prior to the 2008 financial crisis by Chuck Prince, former Citigroup Chairman and Chief Executive. Prince famously stated as follows: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing," M. Nakamoto, Citigroup chief stays bullish on buy-outs, Financial Times (July 9, 2007), available at https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac. Recognizing the potential for things to get "complicated," Prince continued to permit the very trading activities that ultimately resulted in Citigroup receiving one of the largest taxpayer-funded bank "bailout" packages during the 2007-09 crash and economic crisis period. For additional information, see Special Inspector General for the Troubled Asset Relief Program, Extraordinary Financial Assistance Provided to Citigroup, Inc. (SIGTARP 11-002) (Jan. 13, 2011), available at https://www.sigtarp.gov/Audit%20Reports/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf. For a more detailed explanation of Prince's quote, see Better Markets Comment Letter to the CFTC and other financial regulatory agencies Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 2-5 (October 17, 2018), available at https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20on%20New%20Volcker%20Rule%20Proposal.pdf.

[14] See C. Reinhart and K. Rogoff, This Time is Different: Eight Centuries of Financial Folly (2009) (cataloguing serial debt crises over eight centuries and discussing common narratives in each post-crisis generation that market stability will persist indefinitely). However, see J. Cassidy, The Reinhart and Rogoff Controversy: A Summing Up (April 26, 2013), available at https://www.newyorker.com/news/john-cassidy/the-reinhart-and-rogoff-controversy-a-summing-up (discussing a number of methodological issues and potential policy implications of maintaining high debt burdens relative to gross domestic product).

[15] Public Law 111–203, 124 Stat. 1376 (2010).

[16] Congress made clear in section 712(a)(3) of the Dodd-Frank Act that the SEC must issue regulations regarding security-based swap dealers **"in final form not later than 360 days from the date of enactment,"** which elapsed in July 2011, or more than eight years ago. See Title VII—Wall Street Transparency and Accountability, Subtitle A—Regulation of Over-the-Counter Swaps Markets, Part I—Regulatory Authority, Sec. 712(a)(3), Public Law 111–203, 124 Stat. 1376 (2010).

[17] The SEC and Commodity Futures Trading Commission's joint final "security-based swap dealer" definition regulation was published on May 23, 2012. See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant", 77 Final Rules, Fed. Reg. 30596 (May 23, 2012). The Dodd-Frank Act was signed into law in July 2010. See supra fn. 15.

VII of the Dodd-Frank Act—to the 2008 financial calamity. Indeed, the SEC was given jurisdiction over derivatives markets that most directly exacerbated and transmitted risks throughout the financial system during the 2008 financial crash and economic crisis—credit default swaps ("CDS") on mortgage-backed securities ("MBSs") and collateralized debt obligations ("CDOs").

There is a considerable literature describing the multiple causes of the 2008 financial crisis; however, one causal element is irrefutable: **SB-Swaps made the extent of the MBS and CDO speculative boom possible**. In turn, unconstrained speculation proved disastrous. For example, "[b]y January 2009, global banks, insurers, and asset managers had written down $218 billion in losses from their holding of CDOs . . . or 42 percent of their [realized and immediate] crisis-related losses," in addition to "$84 billion of losses on residential mortgage-backed securities."[18] That, of course, does not account for the hundreds of billions of dollars of additional losses that would have been recognized in the absence of the extraordinary government assistance that directly and indirectly bailed out the MBS and CDO markets, including direct, taxpayer-subsidized purchases of CDOs and rescue programs that indirectly ensured performance on SB-Swaps referencing CDOs.[19] It also does not account for the billions of dollars of CDO-*related* losses (including in unregulated, uncollateralized SB-Swaps) and the CDOs and related positions that were held on the books of every major investment bank at dubious, above-market values and in dubious accounting classifications (held-to-maturity) to avoid realizing losses and revealing obvious capital deficiencies.

In short, the rapid deterioration of MBSs within CDO structures led to the massive write-downs and insolvencies among systematically important Wall Street dealers and other intermediaries, spreading panic and contagion throughout the global markets. SB-Swaps not only made that possible but actually amplified the losses and accelerated liquidity constraints.[20] Moreover, SB-Swaps did not just support the unrestrained MBS and CDO speculation in the lead-up to the 2008 financial crisis but also critically, supported the demand for CDOs referencing the

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[18] D. Beltran, L. Cordell, and C. Thomas, Asymmetric Information and the Death of ABS CDOs, Board of Governors of the Federal Reserve System Staff, International Finance Discussion Papers No. 1075 (March 2013), available at https://www.federalreserve.gov/PubS/ifdp/2013/1075/ifdp1075.htm.

[19] See J. Felkerson, A Detailed Look at the Fed's Crisis Response by Funding Facility and Recipient, Public Policy Brief, Levy Economics Institute of Bard College, No. 123 (2012), available at https://www.econstor.eu/bitstream/10419/121982/1/689983247.pdf (calculating "the total amount of loans and asset purchases made . . . from January 2007 to March 2012" and determining that the Federal Reserve's cumulative 2008 financial crisis interventions were "over $29 trillion"). For a discussion of this figure and the endless industry disagreements on the precise final number, see Better Markets, Wall Street's Six Biggest Bailed-Out Banks: Their RAP Sheets & Their Ongoing Crime Spree, Special Report (April 9, 2019), available at https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Wall%20Street%27s%20Six%20Biggest%20Bailed-Out%20Banks%20FINAL.pdf. As we emphasize in that report, the $29 trillion figure is based on a reasonable methodology for calculating the **cumulative** Federal Reserve and U.S. government interventions, but "the precise amount isn't as relevant as its magnitude and long-term impact: It was inconceivably high and will be costing the U.S. and its people for a generation or more." Id. at 33. See also Better Markets, The Cost of the Crisis: $20 Trillion and Counting (July 2015), available at https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis_1.pdf.

[20] Financial Crisis Inquiry Commission, Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, xxiv (January 2011), available at https://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf ("We conclude over-the-counter derivatives contributed significantly to this crisis.").

least creditworthy assets. SB-Swaps offered credit protection for equity and mezzanine CDO tranches, ostensibly "insuring" against (but often really just permitting speculation on) CDO credit deterioration. For dealers, this credit protection facilitated CDO inventory management and speculation—offering exposures similar to shorting underlying MBSs. That made it easier to hold the risk. For investors, SB-Swaps facilitated CDO purchases, and less directly, issuance of the underlying loans on credit terms that otherwise would have been unavailable. The Financial Crisis Inquiry Commission ("FCIC") made its finding on this latter point clearly:

> [T]he issuers of over-the-counter derivatives called credit default swaps, most notably AIG, played a central role [in the CDO issuance machine] by issuing swaps to investors in CDO tranches, promising to reimburse them for any losses on the tranches in exchange for a stream of premium-like payments. **This credit default swap protection made the CDOs much more attractive to potential investors** because they appeared to be virtually risk free, but it created huge exposures for the credit default swap issuers if significant losses did occur.[21]

The understated point in the above FCIC analysis is that huge exposures for CDS issuers also created huge exposures for investors in CDOs, because CDO investors, like issuers, depended on performance on the CDSs.

Without extraordinary U.S.-taxpayer assistance, that credit protection would have turned out to be illusory. CDS dealers, like American International Group Financial Products ("AIG"), if permitted to fail, would have transformed complex, multi-legged positions involving CDOs (long) and CDSs (short) into the equivalent of directional positions on the CDOs alone across Wall Street—and at the worst possible time. In essence, AIG's failure—***and the failure of Wall Street firms to appropriately manage counterparty credit risk in such CDSs without a regulatory mandate***—would have simultaneously sabotaged thousands of multi-position hedging, spread trading, and arbitrage strategies across Wall Street, amplifying directional CDO risk, in particular, in the middle of the most precipitous market crash in generations. Not only was no one in the market to catch the falling knife; allowing AIG to fail would have accelerated the rate at which the knife was falling.[22]

SB-Swaps also formed the basis of synthetic CDOs, which were derivatives on the performance of MBS tranches that drove a number of Wall Street's largest investment banks to the brink of bankruptcy and beyond. Synthetic CDOs amplified the 2008 financial crisis by permitting the creation of multiple financial instruments on the same pool of assets and facilitating

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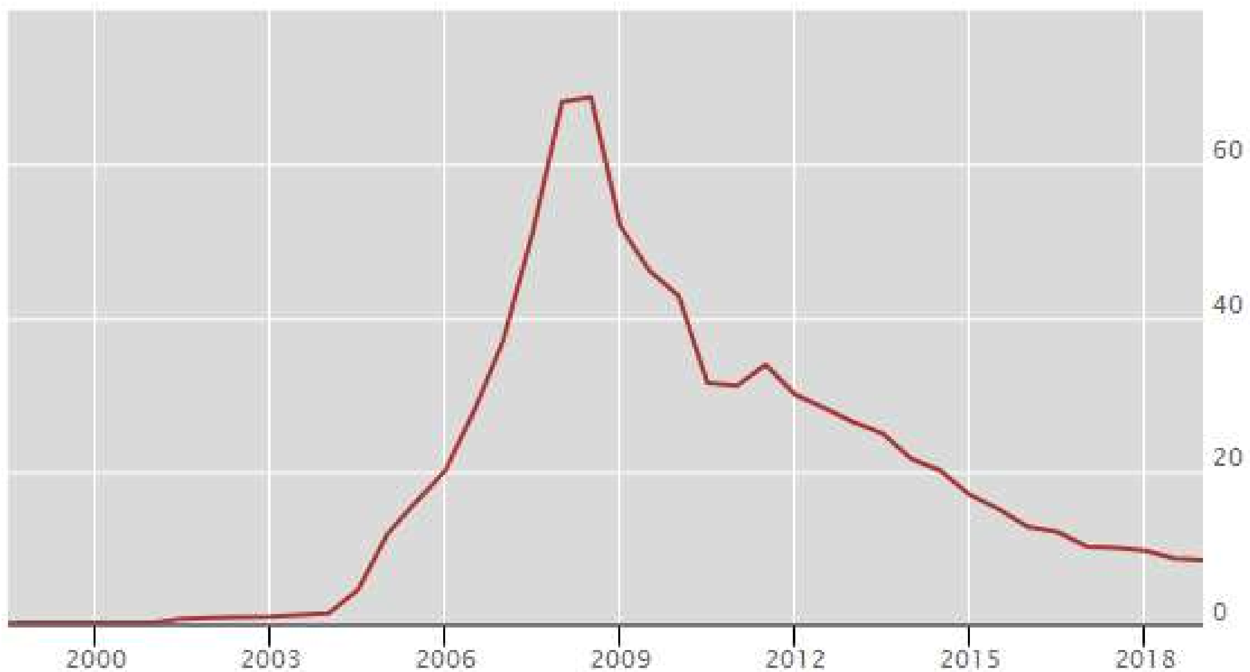
[21] Financial Crisis Inquiry Commission, Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, xxiv (January 2011) (emphasis added).

[22] The top ten indirect beneficiaries of the AIG bailout, in order, were the following, six of whom were foreign banks: Goldman Sachs, Deutsche Bank, Société Generale, Barclays, Merrill Lynch, Bank of America, BNP Paribas, UBS, HSBC Banks USA, and Citigroup. For an analysis of the primary Wall Street beneficiaries of Maiden Lane II & III payouts to AIG counterparties based on a Better Markets analysis, see Testimony of Dennis M. Kelleher, President and CEO Better Markets, Inc., "The State of the Derivatives Market and Perspectives for CFTC Reauthorization," Appendix D, U.S. Senate Committee on Agriculture, Nutrition and Forestry (June 25, 2019), available at https://www.agriculture.senate.gov/imo/media/doc/Testimony_Kelleher%2006.25.19.pdf.

inexpensive, leveraged exposures to MBSs and CDOs.[23] Much of this CDS activity was unproductive, risk-enhancing trading activity, and much of it involved CDS trading without direct exposure to referenced assets. One indication that such CDSs did not serve critical economic purposes is the rapid increase in the use of credit derivatives in the speculative lead up to the 2008 financial crisis and the subsequent precipitous and persistent drop in the use of such derivatives.

Consider the following Bank of International Settlements ("BIS") data:

Outstanding Notional Amounts, All Credit Derivatives
(2000 – 2018)



Source: Bank of International Settlements[24]

To be sure, some of these credit derivatives are regulated as multi-name or index credit derivatives by the Commodity Futures Trading Commission ("CFTC"). Others remain essentially unregulated. But the trend is instructive.

In very recent months—unsurprisingly in the course of a record economic expansion—it has been reported that investor demand for synthetic CDOs has been making a comeback.[25] What

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[23] Unlike CDOs referenced above, synthetic CDOs had no claims on the cash flows from underlying MBSs or similar assets. They were derivatives contracts referencing those assets.

[24] Bank of International Settlements, BIS Statistics Explorer, Derivatives Statistics, Table D5.2, available at https://stats.bis.org/statx/srs/tseries/OTC_DERIV/H.A.A.T.5J.A.5J.A.TO1.TO1.A.A.3.C?t=d5.2&c=&p=20182&i=23.4.

[25] See C. Whittall, RPT—Banks, investors pile back into synthetic CDOs , Reuters (Apr. 29, 2019), available at https://www.reuters.com/article/idUSL5N22B5Q2. See also J. Rennison, Investors flock back to credit product blamed in financial crisis: Greater safety seen in 'synthetic CDOs backed by corporate debt than subprime mortgages, Financial Times (May 3, 2019),

could go wrong? The renewed market interest in synthetic CDOs and similar would be less concerning, of course, if the SEC had properly implemented its statutory mandate to ensure appropriate counterparty and financial system protections. But it has not, and it does not appear to be in a hurry to do so. Instead, the SEC seems more interested in revising the SB-Swaps rules that have not gone into effect, and apparently to placate baseless and far less critical industry claims about operational "burdens."[26]

That is unfortunate and unacceptable. The CDS market alone remains significant in size, exposures, and market value. The global CDS market on all underliers is $8.373 trillion in gross notional value, according to the BIS, and single-name CDSs comprise approximately $3.954 trillion notional of that total.[27] In recent years, likely SB-SDs intermediated transactions with a gross notional amount of approximately $2.9 trillion, 55% of which was conducted through just five dealer accounts.[28] The BIS estimated in 2018 that global credit derivatives had a gross market value of $307 billion, assuming positions are netted (an assumption worthy of further regulatory consideration but beyond the scope of this comment letter).[29]

And the SEC's jurisdiction extends beyond CDSs. Global equity-linked derivatives—which include SB-swaps and swaps, and other types of contracts excluded from the definitions of those products—totaled $6.964 trillion in gross notional outstanding, or $524 billion in gross market value, a sizeable global derivatives market in its own right.[30] The significant risks arising from these less mentioned, multi-trillion-dollar, unregulated derivatives markets should be apparent. But even if they are not, Congress has made clear that the SEC must implement the same Dodd-Frank Act regulatory framework for the SB-Swaps markets, including some of the

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available at https://www.ft.com/content/9c33cea0-6ceb-11e9-80c7-60ee53e6681d. See also C. Whittall, M. Bird, In a Blast from the Financial Crisis Past, Synthetic CDOs Are Back, Wall Street Journal (Aug. 28, 2017), available at https://www.wsj.com/articles/in-a-blast-from-a-financial-crisis-past-synthetic-cdos-are-back-1503912601.

[26] The industry's implementation costs would be exceedingly minimal relative to the substantial benefits of applying the Title VII regulatory framework to SB-Swaps dealing activities in the territorial United States. For example, with respect to business conduct standards, many SB-SDs already have relationship managers and other sales and trading personnel responsible for relationships with potential counterparties that already should be collecting and providing the information required to responsibly engage in a SB-Swaps dealing business. Such dealers also use common technology platforms across affiliates and have built technology infrastructure to interface with third-party applications that facilitate compliance—for example, front-office and documentation management systems that upload and release "good to trade" messages to the front-office trading systems and feeds that push counterparty data, statuses, and representations from the ISDA protocols. In any event, Congress has made the determination to apply Title VII to U.S. territorial activities, so the costs associated with transforming business processes in compliance with Title VII are non-discretionary and instrumental to the financial reforms commanded by statute.

[27] See Bank of International Settlements, Global OTC derivatives market (continued), In billions of US dollars, Table D5, available at https://www.bis.org/statistics/d5_2.pdf. See also Bank of International Settlements, OTC, credit default swaps, by location of counterparty, Notional amounts outstanding, in billions of US dollars, Table D10.5 (June 4, 2019), available at https://www.bis.org/statistics/d10_5.pdf. More than $2.923 trillion of the total amount involves underliers that are either non-investment grade or non-rated. Id.

[28] Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206, 24248 (May 24, 2019).

[29] Bank of International Settlements, Statistical release: OTC derivatives statistics at end—December 2017, 5/11 (May 3, 2018), available at https://www.bis.org/publ/otc_hy1805.pdf.

[30] Id.

equity-linked derivatives markets, that was implemented more than six years ago for the extensive swaps markets. It simply has not.

Instead, the SEC has failed for almost a decade to regulate even the derivatives most directly responsible for the 2008 financial crisis. Again, CDSs offered credit protections that facilitated MBS and CDO issuance, and MBS and CDO issuance led to lending to less creditworthy borrowers.[31] And, again, such lending and issuances would have been impossible without credit derivatives ostensibly managing the risk of default in the underliers. They increased investor demand through the false promise of high risk returns at low risk. They enabled financial institutions to make markets in and maintain large inventories of such MBSs, with minimal regulatory capital—the same MBSs that ultimately had to be written down on their balance sheets during the panic. And they drove those providing credit protection into bankruptcy. Conversely, without SB-Swaps, the risks associated with MBSs and CDOs would have been retained by financial institutions and would have made issuance of CDOs with dubious underliers more difficult, which, in turn, would have served as a critical market constraint on the credit quality of underlying assets.

The danger of the CDS markets and the obvious need for reasonable transparency, risk management, and other regulations were once well-accepted, even in Washington, D.C. Indeed, many officials previously favoring light-touch regulation, voluntary supervision, or even near-complete de-regulation of the SB-Swaps markets revised their views on SB-Swaps in the aftermath of the 2008 financial crisis. Former SEC Chairman Christopher Cox, for example, rightly characterized the need for ***re-regulation*** of the CDS markets during the early stages of the 2008 financial crisis as follows:

> **This regulatory black hole for credit default swaps is one of the most significant issues that we are confronting in the current credit crisis and it requires immediate legislative action** . . . The market for credit default swaps . . . has grown in between the gaps and the seams of the current regulatory system where neither the Commission nor any government agency can reach it. No one has regulatory authority over credit default swaps, not even to require basic disclosure. The over-the-counter credit default swaps market has drawn the world's major financial institutions and others into a tangled web of interconnections where the failure of any one institution might jeopardize the entire financial system. **This is an unacceptable situation in a free market economy.**

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[31] Bernanke, Paulson, and Geithner have acknowledged that "a wide range of financial institutions were too **exposed** to mortgages through direct and **indirect** channels, including the ubiquitous mortgage-backed securities that were considered safe during the housing bubble but became toxic once the bubble popped." See B. Bernanke, T. Geithner, and H. Paulson, Firefighting: The Financial Crisis and Its Lessons, 12 (2019). With respect to disintermediation's effects on underwriting standards, Bernanke, Geithner, and Paulson note the following: "Normally, lenders have strong incentives to be careful about how much they lend and to whom, because they need to get paid back to make money. But in the years before the crisis, Wall Street firms responded to the ferocious global appetite for safe-looking assets by packaging mortgages into increasingly elaborate mortgage-backed securities that they could sell to investors looking for higher returns. The investor demand gave those Wall Street firms an equally ferocious appetite for mortgages that could serve as the raw materials for these securities. And loan originators who knew they could sell their mortgages without retaining any of the risk of default had little incentive to seek creditworthy borrowers . . . The "originate-to-distribute" mortgage model created bad incentives for mortgage originators, and some analysts have blamed it for the entire crisis . . . ." Id. at 17. As noted above, SB-Swaps enabled the issuance of the "increasingly elaborate mortgage-backed securities" that resulted in disintermediation.

> These complex interconnections pose risk to the financial system precisely because of the lack of information about who is exposed to whom. They have created a situation that is ripe not only for rumor and misinformation, but for fraud. This is of even greater concern because . . . Manipulation in this completely unregulated and hidden space can . . . drive prices in the regulated market for securities. **That is why I believe it is so important for Congress to act now to provide regulatory oversight of the credit default swaps market . . . .**[32]

The SEC chairman asked, and Congress answered. The SEC received comprehensive regulatory authority over SB-SDs and the SB-swaps markets in 2010. Nine years later, however, the SEC still does not have comprehensive information on the SB-Swaps markets now under its oversight, and it still has not erected the regulatory framework for the very dealers that caused and spread the 2008 financial crisis through reckless use and abuse of SB-Swaps.

The SEC staff, of course, is not responsible for the current state of the SB-Swap regulatory framework. **That has been the result of a longstanding failure of political will**. And that failure undermines confidence not only in the independence of the U.S. financial regulatory system but also in the rule of law more generally. The current Proposal merely slows progress, provides exceptions to well-considered SEC policies, and unnecessarily increases complexities associated with elements of the SB-Swaps framework that already have been adopted and considered at length by the SEC and potential registrants, and properly so.

II. Context and Summary of the SEC Proposal

The SEC proposes unlawful and expansive guidance excluding so-called "market color" commentary provided by U.S.-located personnel from the de minimis SB-SD registration counting rules, SB-SD business conduct rules, and regulatory and public reporting rules, among others,[33] applicable to SB-Swaps transactions that are arranged, negotiated, or executed by personnel located in a U.S. branch or office of a non-U.S. person (or an agent of such person) ("ANE Transactions"). For the reasons discussed below, these proposed amendments to SB-SD regulations would be unnecessary departures from a proper implementation of the SB-SD regulatory framework, violations of the letter and spirit of the Dodd-Frank Act, and fundamentally

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[32] U.S. Securities and Exchange Commission, Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008), available at https://www.sec.gov/spotlight/disclosureinitiative/roundtable/transcript100808.pdf.

[33] ANE Transactions require compliance with certain major SB-Swap participant regulations. For purposes of this comment letter, we focus on SB-SD implications but many of the observations and issues presented would be equally applicable to major SB-swap participants. In addition, although not directly at issue in the current Proposal, we would like to emphasize that certain critical Title VII requirements are not applicable to ANE Transactions under the SEC's existing regulations, namely clearing and trade execution requirements. As we have previously stated, these critical Dodd-Frank Act requirements should apply to territorial trading activities. See Better Markets, Letter to Secretary of the Securities and Exchange Commission, Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; File No. S7-06-15 (July 13, 2015), available at https://bettermarkets.com/rulemaking/better-markets-comment-letter-application-certain-requirements-security-based-swap. We incorporate ANE Transactions comments in that letter into the administrative record for the current rulemaking.

contrary to statutory objectives of protecting the U.S. financial system and SB-Swaps market participants.

Before addressing the critical flaws in these elements of the Proposal, however, Better Markets would like to commend the SEC for affirming fundamental legal bases for continuing to apply Dodd-Frank Act requirements to ANE Transactions based on a territorial analysis of the SEC's cross-border jurisdiction and, in particular, for rejecting the CFTC's unlawful and overly deferential approach to cross-border sales, trading, and booking practices in the global swaps markets.[34]

III. The SEC's proposed market color guidance would permit non-U.S. legal entities to structure booking entities and practices to evade or avoid certain Dodd-Frank Act requirements, while conducting a substantial SB-Swaps dealing business through trading desks located in the territorial U.S.

SB-Swaps with non-U.S. counterparties that are "arranged, negotiated, or executed" by U.S.-located personnel[35] of a non-U.S. dealing entity (or an agent of such non-U.S. dealing entity) must be included in the dealing entity's SB-SD registration threshold.[36] Such ANE Transactions also are subject to certain requirements in Title VII of the Dodd-Frank Act, namely business conduct standards and reporting requirements.[37] The SEC has explained that the terms "arranging" and "negotiating" within the ANE Transactions standard include all "market-facing activity of sales or trading personnel in connection with a particular transaction, including interactions with counterparties or their agents."[38] Thus, under existing regulations and guidance, ANE Transactions include SB-Swaps arising from market-facing, U.S.-based sales and trading activities, including providing "background information regarding pricing or market conditions associated with particular instruments or with markets more generally" and disseminating

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[34] Indeed, even former CFTC Chairman J. Christopher Giancarlo's White Paper, Cross-Border Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation, recommends that the CFTC change its current cross-border interpretation to more closely reflect the SEC's ANE Transactions regulations: "**Take a territorial approach to U.S. swaps trading activity, including trades that are "arranged, negotiated, or executed" within the United States by personnel or agents of such non-U.S. persons. Nonincidental swaps trading activity in the United States should be subject to U.S. swaps trading rules. Such an approach addresses the current fragmentation of U.S. swaps markets**, with some activity subject to CFTC rules and some activity not subject to CFTC rules. This approach is consistent with the principle – one unified marketplace, under one set of comparable trading rules and under one competent regulator." See J. Christopher Giancarlo, Cross-Border Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation: White Paper (October 1, 2018), available at https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118_0.pdf (emphasis added).

[35] We use the term "U.S.-located personnel" as shorthand for "personnel located in a U.S. branch or office" as that phrase is used throughout SEC regulations governing ANE Transactions.

[36] 17 CFR § 240.3a71-3(b)(1)(iii)(C).

[37] See 17 CFR § 240.3a71-3(c) and Regulation SBSR Rules 908(a)(1)(v) and 908(b)(5).

[38] Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598, 8622 (Feb. 19, 2016). The SEC also explained that the term "execute" refers to "market-facing activity that, in connection with a particular transaction, causes the person to become irrevocably bound under the [SB-Swap] under applicable law." Id.

"information regarding current or historic pricing, volatility or market depth, and [related] trends or predictions" (so-called "Market Color").[39]

The SEC's proposed guidance would permit non-U.S. dealing entities to exclude Market Color commentary provided by U.S.-located personnel from the concepts of "arranging" or "negotiating" for purposes of applying certain Title VII requirements to what otherwise would be considered ANE Transactions. In essence, the SEC's proposed Market Color guidance would **permit non-U.S. dealing entities to evade or avoid the Dodd-Frank Act**, while using their U.S.-located sales and trading personnel to routinely provide non-U.S. counterparties market-conditioning information through traditional marketing and sales-related activities. Those marketing and sales activities include providing "current or historic pricing" on particular SB-Swaps,[40] addressing SB-Swaps-related trading "inquiries,"[41] discussing "depth of market" and "anticipated demand,"[42] and providing "market data and other information,"[43] key activities of Wall Street trading desks.

To rely upon the proposed guidance, U.S.-located personnel of a non-U.S. person would have to meet the following conditions:

- They cannot have client responsibilities (and cannot have been "assigned" to clients) in connection with transactions arising from or occurring in connection with the provision of such Market Color;[44] and
- They cannot receive compensation based on or linked to the completion of such transactions, though some forms of compensation tied to aggregate performance across clients would not violate the condition.[45]

The proposed guidance emphasizes that the designation of subject U.S.-located personnel as salespeople or traders would not per se violate the conditions.[46] These conditions are not further explained, however, and would permit non-U.S. persons considerable discretion to structure SB-Swaps and protocols to evade or avoid the Dodd-Frank Act's requirements otherwise applicable to U.S.-based dealing businesses involving U.S.-located associated persons ("APs") and similar.

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[39] Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206, 24216 (May 24, 2019).

[40] Id. at 24216-24217.

[41] Id.

[42] Id. at 24217.

[43] Id.

[44] Id.

[45] Id., fn. 96 (stating that "[t]he language regarding 'compensation based on or otherwise linked to the completion of transactions' is not intended to extend to such profit-sharing arrangements or other compensation practices that account for aggregated profits, as such arrangements would not be expected to incentivize U.S. personnel in a similar manner or to a similar degree as compensation that is directly linked to the success of individual transactions").

[46] Id. at 24216, fn. 95.

A. The proposed Market Color guidance creates more ambiguities than it resolves and is explained in terms that fall squarely within the plain meaning of "arranging, negotiating, and executing."

The proposed Market Color guidance introduces ambiguities into the SEC's existing, bright-line regulations governing ANE Transactions. Recall that the SEC's final guidance on ANE Transactions delineated between client-oriented activities by explaining that "execution" merely contemplated "a market-facing act that, in connection with a particular transaction, causes the person to be irrevocably bound under the [SB-Swap] under applicable law,"[47] whereas "arranging" and "negotiating" collectively contemplated all other market-facing "interactions with counterparties or their agents."[48] The SEC now proposes to confuse these bright-line concepts. For example, the proposed guidance would permit U.S.-located sales and trading personnel—***designated as such on a U.S.-located, market-facing trading desk***—to provide each of the following:

- Background information regarding pricing or market conditions associated with particular instruments or markets more generally;
- Information on current or historic pricing;
- Information regarding volatility or market depth; and
- Information on trends or predictions regarding pricing, volatility, or market depth, as well as other information concerning conditions and trends.

Each of these activities is essentially indistinguishable from "marketing," "soliciting," or conditioning the market or clients for SB-Swaps. Indeed, the identified Market Color activities fall within the plain meaning of the terms "arrange" and "negotiate." The dictionary definition of "arrange" includes "bringing about an agreement or understanding concerning."[49] Black's Law Dictionary similarly defines "negotiate" to mean "to discuss or arrange a sale or bargain; to arrange the preliminaries of a business transaction."[50] In the SB-Swaps context, the proposed Market Color activities—e,g., providing indicative pricing information—include the very means used to "bring about an agreement or understanding" and form an inseverable element of sales and trading communications on "preliminaries."

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[47] Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598, 8622 (Feb. 19, 2016), available at https://www.govinfo.gov/content/pkg/FR-2016-02-19/pdf/2016-03178.pdf.

[48] Id.

[49] Definition of "Arrange," Merriam-Webster Dictionary (2019), available at https://www.merriam-webster.com/dictionary/arrange.

[50] Definition of "Negotiate," the Black's Law Dictionary Free Online Legal Dictionary 2nd Ed., available at https://thelawdictionary.org/negotiate/ (emphasis added).

The Proposal nevertheless remains largely silent on the challenges of delineating market-facing activities requiring SB-Swaps to be treated as ANE Transactions and market-facing activities excluded pursuant to the Market Color guidance. The SEC solicits public comment on that issue. But it provides little to satisfactorily address it (and therefore little to comment on). The SEC merely purports to distinguish "actively market[ing]"[51] SB-Swaps from the above identified market-facing activities, which themselves involve routine marketing practices on U.S.-located trading desks. There is no explanation, for example, of the threshold of routine marketing activities that may be regular ***enough*** to constitute "actively" marketing. And the proposed "actively marketing" analysis would apparently turn on the **regularity**, rather than the **nature**, of the U.S.-located sales and trading activities conducted on behalf of the non-U.S. person. That conceptual issue all but acknowledges the apparent equivalence of certain existing ANE Transactions activities and the Market Color activities proposed to be excluded from the reach of the Dodd-Frank Act.[52]

For these reasons, it would be exceedingly difficult to ascertain limits on the scope of the Market Color guidance. For example, it would exclude solicitation activities even if conducted by **U.S.-located personnel designated to conduct sales and trading activities on behalf of a dealing entity.** And it would exclude solicitation activities **even if the very same dealing-related activities on the very same trading desks—when facing U.S. counterparties—would be subject to the full panoply of Title VII requirements**. These two implications, in themselves, demonstrate that the proposed guidance is conceptually nonsensical and practically unworkable from a supervisory standpoint. But perhaps most concerning, the proposed guidance would encourage even U.S.-based financial conglomerates to re-structure non-U.S.-facing SB-Swaps activities in a manner that altogether avoids the imposition of U.S. law. The SEC's encouragement in this regard is directly contrary to its stated intent in imposing the already limited[53] ANE Transactions requirements when SB-Swaps arise from the sales and trading activities, including Market Color activities, of U.S.-located personnel.

In addition, with respect to statutory disqualifications,[54] the SEC has determined that effecting or being involved in effecting SB-Swaps means, in essence, participating in "key aspects

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[51] Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206, 24216 (May 24, 2019).

[52] We note that the SEC previously revised regulations to address the unintended interpretation of the term "actively" to imply some minimum amount trading activities. See Securities and Exchange Commission, Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, 80 Fed. Reg. 48964, 48976 (Aug. 14, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-08-14/pdf/2015-19661.pdf ("Upon further consideration, we did not mean to imply (by use of the term 'actively') that there is some minimum amount of trading a person working on a trading desk must be involved with to be considered 'involved in effecting' security-based swap transactions. In general, our focus is on the type of activity, not the amount of activity.").

[53] See fn. 30 supra.

[54] Exchange Act section 15F(b)(6) makes it unlawful for an SB-SD to permit an AP who is subject to a statutory disqualification to ***effect*** or ***be involved in effecting*** SB-Swaps on behalf of the SB-SD if it knew, or in the exercise of reasonable care should have known, of the statutory disqualification. 15 U.S.C. 78o– 10(b)(6). Exchange Act Section 3(a)(70) generally defines the term "persons associated with" an SB-Swaps entity to include the following: (1) any partner, officer, director, or branch manager of an SBS Entity (or any person occupying a similar status or performing similar functions); (2) any person directly or indirectly controlling, controlled by, or under common control with an SB-SD, among other regulated SB-Swaps categories; or (3)

of the overall process of effecting transactions, including ***sales***, ***booking*** and cash and collateral management activities."[55] The SEC has further explained that its AP-related regulations focus on persons that "have the ability, through their conduct (intentional or unintentional), to increase risks to investors, counterparties and the markets."[56] **In essence, then, the SEC's guidance seeks to exempt some of the very market-facing activities that in other contexts requires sales designations on account of the acknowledged "risks to investors, counterparties, and markets."[57]** Consider, too, the SEC's guidance in this context:

> [W]e believe the term "involved in effecting [SB-Swaps]" generally means engaged in functions necessary to facilitate the SBS Dealer's . . . business, including . . . (1) Drafting and negotiating master agreements and confirmations; (2) recommending [SB-Swap] transactions to counterparties; (3) **being involved in executing [SB-Swaps] transactions on a trading desk**; (4) **pricing security-based swap positions**; (5) managing collateral for the SBS Entity; and (6) directly supervising persons engaged in the activities described in items (1) through (5) above.[58]

Note the inclusion of "pricing" information both in the description of solicitation activities for APs involved in effecting SB-Swaps as well as the description of Market Color activities that would be excluded from the concepts of "arranging" and "negotiating" under the Proposal. It is unclear how the SEC intends to distinguish AP dealing through the quotation of pricing information from the Market Color activities that involve providing indicative prices, historical prices, and even executable current prices to potential counterparties, if at all. Without such a distinction, the Market Color guidance amounts to a sweeping de facto repeal of territorial dealing activities from the Dodd-Frank Act.

Unfortunately, we are unable to recommend any conceptual distinctions between market-facing activities that delineate "arranging" and "negotiating," on the one hand, and providing Market Color on the other. This is because providing Market Color cannot be severed, in principle, from "arranging" and "negotiating" SB-Swaps, which involves Market Color activities. Because these activities are inextricably tied, especially ***when conducted by the same sales and trading personnel that are internally designated on account of their dealing activities***,[59] the SEC must

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any employee of an SB-SD, among other regulated SB-Swaps categories. 15 U.S.C. 78c(a)(70). The phrase generally excludes ministerial and clerical employees but covers both natural persons and corporate entities (affiliates). 15 U.S.C. 78c(a)(9).

55 Securities and Exchange Commission, Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, 80 Fed. Reg. 48964, 48976 (Aug. 14, 2015).

56 Id.

57 This emphasis on solicitation and marketing activities informed the CFTC's interpretation of cognate AP provisions under the Commodity Exchange Act ("CEA"). For example, CFTC Regulation 1.3(aa) defines the term "associated person" to mean "any natural person who is associated in any of the following capacities with . . . [a] swap dealer or major swap participant as a partner, officer, employee, agent . . . in any capacity that involves: (i) The **solicitation or acceptance of swaps** (other than in a clerical or ministerial capacity); or (ii) The supervision of any person or persons so engaged." 17 CFR §1.3(aa).

58 Id. (emphasis added).

59 The SEC somewhat cryptically states that it "does not believe that the [ANE Transactions] test invariably must be triggered by the presence of U.S. personnel who are designated as salespersons or traders when their activity is **too limited to**

abandon the proposed Market Color guidance in favor of the existing, clear, and prudent ANE Transactions regulations and guidance provided by the SEC only three years ago (and that remains unimplemented).

The conceptual issues noted above also mean that no regulation can be drafted precisely enough to close the door on expansive interpretations that would be driven the by the economic interests of U.S.-located firms seeking to do unregulated or less regulated business in non-U.S. jurisdictions, while benefiting from a U.S. dealing business. Wall Street banks inevitably would find it in their economic interest to operate within the U.S. but without the laws that apply to all other activities in the U.S. That makes commercial sense for them (and it is predictable therefore that they would ask for exit from U.S. requirements). But the SEC does not have to—and must not—provide that exit, in particular where the guidance clearly violates the activities-based mandate of the Dodd-Frank Act[60] as well as longstanding legal principles regarding the application law within a sovereign's territory.[61]

B. The proposed Market Color guidance would permit the precise types of evasive or avoidance measures, like corporate structuring and cross-border booking, that motivated the ANE Transactions regulations.

implicate the principles underlying uses of the test." See Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206, 24216 (May 24, 2019).

[60] Exchange Act section 78c(71) defines the term, "security-based swap dealer" ("SB-SD"), to mean any person that does any of the following dealing ***activities***: (1) holds itself out as a dealer in SB-Swaps; (2) makes a market in SB-Swaps; (3) regularly enters into SB-Swaps with counterparties as an ordinary course of business for its own account; or (4) engages in any activity causing it to be known in the trade as a dealer or market-maker in SB-Swaps. 15 U.S.C. § 78c(71). To clarify the reach of Exchange Act section 78c(71), the Dodd-Frank Act added a new provision, Exchange Act section 30(c), to provide that SB-Swap provisions shall not apply to any person "insofar as such person ***transacts*** a business in security-based swaps **without the jurisdiction of the United States**, unless such person transacts such business in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent evasion" of Title VII of the Dodd-Frank Act. 15 U.S.C. § 78dd(c). The activities-based statutory SB-SD definition, the SEC's further definition of that term and related dealer-trader distinction guidance (e.g., focused on dealing activities, such as providing liquidity, providing advice, regularly soliciting clients, and using interdealer brokers), and the statutory and regulatory requirements applicable to SB-SDs (e.g., external business conduct standards) all emphasize **activities-based** analyses and transactional requirements, not risk-based considerations. The SEC has rightly noted in recent years that "[n]either the statutory definition of [SB-SD] nor [its] further definition of that term turns primarily on the presence of risk or [even] on the purchase or sale of any security, including a security-based swap." Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598, 8614 (Feb. 19, 2016). Even the statutory prohibition on the extraterritorial application of Title VII applies solely to **activities** without the jurisdiction of the SEC. The term "transacts" itself emphasizes dealing activities effecting or immediately leading to a transaction. SB-Swap dealing activities occurring on a New York or other U.S.-based trading desk are not affected by the prohibition in Exchange Act section 30(c), because, as repeatedly recognized by the SEC and the courts in interpreting similar language, **territorial dealing activities are squarely *within the jurisdiction of the United States***. Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598, 8614 (Feb. 19, 2016). The Exchange Act section 30(c) prohibition therefore does not, and cannot be reasonably read to, apply to such territorial dealing activities. Indeed, the prohibition, by its own words and description, applies to ***extraterritorial*** activities, not those conducted within the U.S. itself.

[61] Jurisdiction to regulate activities occurring within a country's own borders has never been seriously questioned by U.S. courts and most have comfortably extended prescriptive jurisdiction beyond persons and activities within the "territorial" United States when there are direct and significant effects on U.S. commerce. See Restatement (Fourth) of the Law—The Foreign Relations Law of the United States (2018), American Law Institute (2019) (noting that generally the United States exercises prescriptive jurisdiction with respect to "(a) persons, property, and conduct within its territory; [and] (b) conduct that has a substantial effect within its territory").

The Market Color guidance appears to be based, in significant part, on self-serving but false industry claims—including those that have been pitched for years by Citigroup (one of the largest recipients of extraordinary government assistance during the 2008 financial crisis[62])—that the final ANE Transactions regulations ("ANE Transactions Rule")[63] are too ambiguous to implement. Even a cursory examination of the ANE Transactions Rule, however, reveals that the purported "ambiguities" are really efforts by industry to relitigate its own policy arguments that were rightly rejected by the SEC.

This brings to mind the Upton Sinclair quote, **"[i]t is difficult to get a man to understand something when his salary depends on his not understanding it."**[64] The industry issue is not ambiguity; it is the clarity with which the SEC acted in 2016, which seeks to protect the public interest as required by law rather than the dealers' profit maximization.

In fact, it is the proposed Market Color guidance's ambiguities that raise the very structuring (evasion or avoidance) concerns that the SEC cites as a primary rationale for the ANE Transactions Rule. Under the proposed Market Color guidance, non-U.S. dealing entities conceivably could instruct U.S.-located persons to provide indicative quotes for particular dealing swaps, communicate other market or pricing information, and market trading strategies from a New York trading desk—all without being subject to SB-SD registration, business conduct standards, and reporting requirements under the Dodd-Frank Act. **The guidance appears to permit—indeed, encourage—non-U.S. dealing entities to evade or avoid the imposition of the Dodd-Frank Act**, because such territorial market-facing sales and trading activities would be permitted based on the fiction that ***limited*** indicative pricing, notional amounts, and other economic terms can be preliminarily agreed in the U.S. and subsequently passed to an overseas counterpart or system for final "arrangements" or "negotiations" tantamount to "execution."

Consider the following hypothetical fact pattern, which we believe could be viewed as consistent with the Market Color guidance:

> Non-U.S. dealer uses Salesperson A on a New York trading desk to facilitate transactions in SB-Swaps with non-U.S. clients. Salesperson A is designated as sales or trading personnel for the non-U.S. dealer and receives compensation that reflects, in part, the performance of the trading desk for covered asset classes, as well as the overall performance of the line-of-business in which Salesperson A is located. Salesperson A contacts potential clients, pitches them on SB-Swaps-

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[62] For additional information, see Special Inspector General for the Troubled Asset Relief Program, Extraordinary Financial Assistance Provided to Citigroup, Inc. (SIGTARP 11-002) (Jan. 13, 2011), available at https://www.sigtarp.gov/Audit%20Reports/Extraordinary%20Financial%20Assistance%20Provided%20to%20Citigroup,%20Inc.pdf.

[63] Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598 (Feb. 19, 2016).

[64] Upton Sinclair, I, Candidate for Governor: And How I Got Licked, pg. 109, University of California Press (1994) (originally published 1934).

> related strategies, provides information on risks-rewards, discusses term sheets, provides information on market trends, and even quotes indicative pricing.
>
> Once the strategy is agreed with the client, Person A forwards "indicative" details of the initial transactions to a trading desk in London—in a preliminary trading ticket—for "execution," thereby relying on the proposed Market Color guidance to attribute all activities leading to the SB-Swaps transaction solely to the non-U.S. trading desk as part of the Market Color exclusion.

If that trade workflow sounds like a strategy structured to evade or avoid U.S. law, that is because it would be designed to do precisely that; and, unfortunately, the <u>above</u> hypothetical structure would appear to be consistent with the pending proposal.[65]

The SEC is quite explicit, in fact, about the permissibility of excluding from ANE Transactions requirements those sales and trading activities that involve a combination of U.S. and non-U.S.-located personnel, provided the role of U.S.-located personnel remains sufficiently **limited**. Consider the following proposed guidance:

> U.S. personnel may engage in limited market-facing activity such as providing market-related information to counterparties **in response to inquiries**, or **providing market data or other information that helps to set the price associated with a [SB-Swap] transaction** that otherwise is negotiated by non-U.S. personnel. When the remaining market-facing activity connected with a transaction occurs outside the United States, **such *limited* market-facing activity by U.S. personnel standing alone** does not trigger the concerns and regulatory interests that underpin the various uses of the "arranged, negotiated, or executed" test in connection with the transaction.[66]

The SEC contends, in essence, that Market Color communications are not solicitation activities of the type that merit U.S. regulatory oversight, even if they are based in the territorial U.S. and facilitate SB-Swaps execution within a U.S. bank holding company. That is simply wrong. The

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[65] In contrast, consider the description of the operation of the ANE Transactions Rule, where the commission rightly went through great lengths to clarify the following: "[W]e note that . . . "arranging," "negotiating," and "executing" also **include directing other personnel to arrange, negotiate, or execute a particular [SB-Swap].** In other words, **<u>sales and trading personnel of a non-U.S. person who are located in the United States cannot avoid application of this rule by simply directing other personnel to carry out dealing activity</u>**, and we would view personnel located in a U.S. branch or office who direct personnel not located in the United States to arrange, negotiate, or execute a [SB-Swap] transaction as themselves arranging, negotiating, or executing the transaction. Similarly, personnel directing the arranging, negotiation, or execution of [SB-Swaps] include personnel located in a U.S. branch or office that specify the trading strategy or techniques carried out through algorithmic trading or automated electronic execution of [SB-Swaps], even if the related server is located outside the United States." Securities and Exchange Commission, <u>Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception</u>, 81 Fed. Reg. 8598, 8623 (Feb. 19, 2016). The proposed guidance ostensibly relates to arranging and negotiating—not execution—and such activities encompass dissemination of trading information, pricing information, term sheets, and similar.

[66] Securities and Exchange Commission, <u>Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception</u>, 81 Fed. Reg. 8598 (Feb. 19, 2016) (emphasis added).

vague Market Color guidance would not, in reality, be "so limited" in effect as to not implicate U.S. regulatory interests, as the SEC repeatedly asserts.[67] Rather, it would be ***so extensive*** in effect that the wholesale reorganizing of trading desks and practices to avoid the Dodd-Frank Act would be virtually certain.

Moreover, the SEC is focused on the wrong personnel. If U.S.-located personnel provide pricing information and other trading and risk-reward information to condition the market for a particular SB-Swap transaction, that is core U.S.-based sales activity, even if the SB-Swap transaction ***also*** is "arranged" or "negotiated" by non-U.S. personnel in certain respects. The involvement of non-U.S.-located persons is not as relevant as the fact that the solicitation either was initiated in the U.S. or initiated abroad and passed to the U.S. for marketing or sales purposes. In either scenario, the involvement of U.S.-located personnel per se cannot be said to be incidental. Second, as discussed above, the supposed "limited market-facing activity" referenced in the SEC's explanation does not clearly enough delineate when market-facing activities are "limited" and when they are not.

In our hypothetical, the Dodd-Frank Act's business conduct and reporting requirements apparently would not apply (as they would to ANE Transactions) and the SB-Swaps dealing transactions would not count towards SB-SD registration thresholds (as they would to ANE Transactions). This would be the case, moreover, even if the following were individually and collectively true:

- The SB-Swap pitched on behalf of the non-U.S. dealer was agreed in all material respects (but did not yet irrevocably bind the counterparties) before being routed to a non-U.S. trading desk for execution;
- The designated sales and trading person(s) that marketed the SB-Swap, provided pricing information, conditioned the market, served as the sole contact(s) (but not formal "relationship manager(s)") interacting with the client, and facilitated agreement on economic terms were U.S.-located;
- The sales and trading activities conducted by the U.S.-located person(s) were dealing activities; and
- The U.S.-located trading desk that such sales and trading person(s) are associated with regularly engages in U.S. SB-Swaps dealing activities.

If the SEC does not remedy this possibility—namely by abandoning the Market Color guidance in its entirety—there can be no doubt that the industry would adopt an expansive interpretation of the SEC's language and use it as a means to evade or avoid most of the requirements applicable to ANE Transactions. In other words, the guidance would permit or ***even encourage*** non-U.S. dealing entities to "exit the Title VII regulatory regime without exiting the U.S. market."[68]

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[67] See Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206, 24216 (May 24, 2019).

[68] Id.

C. The de facto wholesale exemption from the Dodd-Frank Act effected by the Market Color guidance would impede public interest objectives directly pertinent to ANE Transactions.

As should be clear, the SEC's proposed Market Color guidance encompasses a host of SB-Swaps marketing and sales activities that implicate the regulatory interests that the Dodd-Frank Act and the SEC sought to address through the ANE Transactions requirements. For example, business conduct standards designed to protect counterparties and reasonably ensure some measure of fair dealing and disclosure conceivably would not be applicable to routine, high-volume sales activities of U.S.-located personnel. Instead, the Proposal would permit the precise types of SB-Swap "arranging, negotiating, and executing" activities mandated to be regulated under Title VII of the Dodd-Frank Act to be conducted without the financial stability and counterparty protections of U.S. law.

Even standard material risks, conflicts of interest, and other disclosures directly pertinent to ANE Activities within the territorial U.S. would be inapplicable to U.S.-based dealing under the Proposal.[69] That is an especially ironic, unlawful, and inappropriate outcome, given the types of misrepresentations and misconduct revealed in recent SEC enforcement actions. For example, the SEC's minimal enforcement actions relating to the sale of synthetic CDOs alone—the infamous derivatives products at the center of the 2008 financial crisis—demonstrate that, if anything, business conduct standards should be more broadly and aggressively applied:

- The SEC entered into a record $550 million settlement with Goldman Sachs based on Goldman's acknowledged misrepresentations in marketing materials for the Abacus 2007-AC1 offering.[70]

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[69] Such disclosures already are not as meaningful as intended by Congress, because most are standardized electronic disclosures disseminated during onboarding in conjunction with the ISDA protocols.

[70] See Goldman Sachs to Pay Record $550 million to Settle SEC Charges Related to Subprime Mortgage CDO: Firm Acknowledges CDO Marketing Materials Were Incomplete and Should Have Revealed Paulson's Role, SEC Litigation Release 21592 (July 15, 2010), available at https://www.sec.gov/litigation/litreleases/2010/lr21592.htm. See also Consent of Defendant Goldman, Sachs & Co., SEC v. Goldman, Sachs & Co. and Fabrice Tourre, 10-CV-3229 BSJ, available at https://www.sec.gov/litigation/litreleases/2010/consent-pr2010-123.pdf (demonstrating that the Goldman Sachs consented to the entry of final judgment "[w]ithout admitting or denying the allegation"). Although the SEC Litigation Release 21592 emphasizes that its "enforcement action against Goldman related to the ABACUS 2007-AC1 CDO . . . does not settle any other past, current or future SEC investigations against the firm," the lack of subsequent action and later published information on egregiously lenient consent orders agreed with Goldman Sachs and Citigroup for separate claims relating to the Class V Funding III synthetic CDO (see infra fn. 72) has raised questions as to whether either firm has been held sufficiently accountable for its CDO-related misconduct and misrepresentations in the lead-up to the 2008 financial crisis. The Goldman Sachs consent order relates to conduct in connection with a **single** structure, though tens of billions of dollars of such instruments were separately underwritten and may have involved similar, or identical, misconduct. See S. Beck, The SEC's Internal Battles Over Goldman Sachs Probe: In the Abacus case, the Securities and Exchange Commission secured a $550 million settlement from Goldman and a civil fraud verdict against former Goldman VP Fabrice Tourre. But one senior SEC lawyer thought the agency wasn't aggressive enough, newly released transcripts show, The American Lawyer (Apr. 8, 2014) (noting "deep internal divisions at the SEC over the investigation and charging of that case, as one veteran lawyer relentlessly pushed for the SEC to target a more senior Goldman executive, and ultimately failed").

- The SEC entered into a $153.6 million settlement with J.P Morgan for similar misrepresentations relating to the Squared CDO 2007-1.[71]
- The SEC entered into a $285 million settlement with Citigroup based on misrepresentations relating to the Class V Funding III synthetic CDO.[72]

In each case, the global Wall Street bank involved was charged by the SEC with failing to adequately disclose conflicts of interest in the process affecting the fundamental economic value of the synthetic CDO—the selection of the reference CDOs. And these are just the most prominent examples of illegal conduct in the marketing of synthetic CDOs, one product within the SEC's jurisdiction.[73]

One quite logical and reasonable means for the SEC to address concerns about conflicts of interest would be to apply the conflicts of interest disclosure requirements mandated by Congress. But, of course, **the even more important means for the SEC to address misconduct is to ensure that enforcement actions actually deter it**—and do not merely disclose it away—for example, by bringing substantive fraudulent charges against institutions and individuals, including, in particular, supervisors and senior executives.

Moreover, the SEC states that "depending on the particular facts and circumstances," the federal securities laws, "including applicable antifraud provisions, still ***may*** apply to that [Market Color] activity."[74] **There simply is no compelling rationale for ceding, or even potentially ceding, any anti-fraud authority over SB-Swaps transactions conducted in the territorial U.S.** Indeed, without SB-Swaps reporting and pre-execution communications records that otherwise would be created, maintained, and retained to demonstrate fraudulent conduct, the SEC's anti-fraud authority already may prove difficult to use. The SEC itself once acknowledged

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[71] See JP Morgan Securities to Pay $153.6 Million to Settle SEC Charges of Misleading Investors in CDO Tied to U.S. Housing Market, SEC Litigation Release No. 22008 (June 21, 2011), available at https://www.sec.gov/litigation/litreleases/2011/lr22008.htm. See also the accountability concerns raised infra in fn. 70 and fn. 72.

[72] See SEC v. Citigroup Global Markets Inc., Complaint, Case No. 11-CV-07387-JSR (S.D.N.Y.) (Oct. 19, 2011), available at https://www.sec.gov/divisions/enforce/claims/citigroup-global-complaint.pdf. See also Final Judgment as to Defendant Citigroup Global Markets Inc., SEC v. Citigroup Global Markets Inc., 11 CIV 7387, available at https://www.sec.gov/divisions/enforce/claims/citigroup-global-final-judgement.pdf (demonstrating that the Citigroup Global Markets Inc. consented to the entry of final judgment "[w]ithout admitting or denying the allegation"). See also Better Markets, Inc., Memorandum of Law in Support of Motion to Intervene, Civil Action No. 1:11-cv-07387-JSR, SEC v. Citigroup Global Markets, Inc., 1, available at https://bettermarkets.com/sites/default/files/SEC%20v.%20Citi%20%28SDNY%29-%20Mem%20of%20Law%20in%20support%20of%20motion%20to%20intervene-%2011-3-11_0.pdf (noting for the United States District Court for the Southern District of New York that "recent revelations of information material to the Proposed Settlement which the SEC has not brought to the attention of the court, including the SEC's history of sanctioning Citigroup for securities fraud violations to no apparent effect and **Citigroup's claim that the Proposed Settlement purportedly for this one CDO deal in fact is ending the SEC's investigation of all of Citigroup's CDO deals which exceed $145 billion**"). See J. Eisinger and J. Bernstein, Did Citi Get a Sweet Deal? Bank Claims SEC Settlement on One CDO Clears It on All Others, ProPublica (Oct. 20, 2011), available at https://www.propublica.org/article/did-citi-get-a-sweet-deal-banks-says-sec-settlement-on-one-cdo-clears-it-on.

[73] See, e.g., J. O'Hare, Synthetic CDOs, Conflicts of Interest and Securities Fraud, Univ. of Richmond Law Review, Vol. 48, No. 2 (2014), available at https://ssrn.com/abstract=2507875.

[74] Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206, 24217, fn. 97 (May 24, 2019).

this concern in considering whether to fully exempt ANE Transactions from the Dodd-Frank Act requirements:

> [A] significant proportion of activity in the [SB-Swaps] market that is carried out within the United States—particularly as financial groups respond to the competitive pressures . . . likely would involve counterparties that are not subject to our regulations or oversight. Dealers accounting for significant volumes of [SB-Swap] dealing activity in the United States—and **together potentially accounting for a significant majority of all activity in the United States**—would not be subject to Title VII recordkeeping and reporting requirements, which would significantly impede our ability to monitor the market for manipulative and abusive conduct on the part of dealers or other market participants.[75]

From a legal and a policy perspective, there is simply no rationale, much less a compelling one, for exempting SB-Swaps dealing activities by the most dominant SB-swaps dealing entities from the SEC's oversight. That would be a clear violation of the SEC's Title VII mandate, in particular when such exemption by the SEC's own admission may extend to "a significant majority of all [SB-Swap] activity in the United States."[76]

The proposed Market Color guidance does not just permit non-U.S. dealing entities to evade or avoid the Dodd-Frank Act, it actually encourages it. That is problematic enough with respect to non-U.S. dealers. But dominant ***U.S.*** SB-SDs would be permitted to structure SB-Swap transactions to avoid the Dodd-Frank Act as well, and there can be little doubt that they rationally would seek to do so. The primary concern of derivatives dealers—U.S.-based or otherwise—is protecting market power and profits, and like all other commercial enterprises, they are always interested in engaging in unregulated or less regulated activities to that end.[77] That is why the SEC rightly called the lobbying interests for the global derivatives industry on the consequences of permitting dealing entities to escape U.S. regulation of U.S.-located activities:

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[75] Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598, 8616 (Feb. 19, 2016).

[76] Id.

[77] The Dodd-Frank Act was intended to promote fair competition within the SB-SD regulatory framework. We agree—again—with the SEC's own well-considered views three years ago: "Competitive disparities would arise as financial groups that use **non-U.S.-person dealers to carry out their dealing business[es] in the United States find themselves able to exit the Title VII regulatory regime without exiting the U.S. market** with respect to their [SB-Swap] dealing business[es] with non-U.S.-person counterparties (including non-U.S.-person dealers). **These dealers likely would incur fewer costs related to their dealing activity in the United States than U.S.-person dealers transacting with the same counterparties, and non-U.S. person counterparties likely would also find that they incur lower costs and obtain better pricing by entering into [SB-Swaps] with non-U.S. dealers that are not required to register as [SB-SDs].**" Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598, 8616 (Feb. 19, 2016). Fair competition, it should be noted, is an especially critical issue in the relatively concentrated SB-Swaps markets, where "dealers appear to enjoy market power as a result of their small number and the large proportion of order flow that they privately observe." See Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206, 24249 (May 24, 2019).

> **The commenters' suggested approach would permit hundreds of billions of dollars in annual notional transaction activity** (including most or all of the interdealer business in [SB-Swaps] with U.S. underliers), **representing two-thirds or more of all security-based swap transactions that currently involve U.S. counterparties or U.S. activity, to be carried out, at least in part, within the United States without being subject to Title VII dealer regulation, much as if Title VII had never been enacted.**[78]

Those are the SEC's conclusions, and they remain applicable to the de facto exemption sought by the current Proposal. Proceeding to adopt proposed provisions **knowing that evasion or avoidance is a direct, foreseeable, and understood consequence** simply would be a shocking departure from the mission of the SEC and violate the law mandating the SEC to do otherwise.

Concerns about evasion or avoidance are especially critical in the SB-Swaps context, given the concentration of activities in U.S.-based financial institutions. In certain markets, legal entities within U.S. bank holding companies do not just participate in the market—they, in essence, ***are*** the market:

> Financial groups based in the United States are also involved in a majority of interdealer transactions in North American corporate single-name CDS. Of the 2017 transactions on **North American corporate single-name CDS between two ISDA-recognized dealers and their branches or affiliates, 94% of transaction notional volume involved at least one account of an entity with a U.S. parent**.[79]

That is a huge concentration of dealing activities, profits, and risks. Under such circumstances, the SEC should be wary of facilitating any exit from Dodd-Frank Act requirements through trade booking gimmicks that elevate form over substance.

In this regard, the financial industry's lobbying organizations have published numerous white papers disingenuously emphasizing the dangers of so-called fragmentation of the global derivatives markets. Fragmentation, they claim, has been a consequence of applying U.S. regulatory requirements to activities in non-U.S. jurisdictions.[80] However, there is a certain irony to that refrain, because **the Market Color guidance they so eagerly crave in this context would increase, rather than reduce, fragmentation and operate to the detriment of the U.S. counterparties.** Encouraging further bifurcation of U.S. and non-U.S. markets so readily is almost certain to impair liquidity and increase costs on U.S. counterparties, the intended beneficiaries of the Dodd-Frank Act's derivatives markets reforms. Again, consider the SEC's own views on fragmentation not long ago:

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[78] Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598, 8616 (Feb. 19, 2016).

[79] Id.

[80] See, e.g., International Swaps and Derivatives Association, Inc. ("ISDA"), Regulatory Driven Market Fragmentation (Jan. 2019), available at https://www.isda.org/a/MlgME/Regulatory-Driven-Market-Fragmentation-January-2019.pdf ("ISDA is cognizant of the fact that the issue of regulatory driven market fragmentation may seem to some like an attempt to use jurisdictional differences in regulation to achieve a better regulatory outcome on a global basis (in other words, a form of regulatory arbitrage").

> [I]f a majority of [SB-Swaps] dealing activity in the United States, including most or all interdealer activity in the United States, is carried out by non-U.S. persons that are not subject to Title VII dealer regulation, **the market is likely to fragment into two pools**. The larger pool likely would consist of transactions that are carried out by unregistered non-U.S.-person dealers with non-U.S.-person counterparties, including the largest dealers in the [SB-Swaps] market, while the smaller pool likely would be limited to U.S.-person counterparties and registered dealers that do business exclusively with those U.S-person counterparties (and that may or may not themselves be U.S. persons). In other words, absent these rules [applying Title VII of the Dodd-Frank Act to ANE Transactions], **U.S. market participants likely would find themselves confined to a shallower liquidity pool with worse pricing than would be available to non-U.S. persons, even though those non-U.S. persons likely would themselves be using personnel, or facing dealers using personnel, located in the United States to arrange, negotiate, or execute similar transactions**.[81]

The proposed Market Color guidance does not sufficiently examine or even discuss the extent of such costs and the detriment to the public interest that would occur from over-deference to the derivatives industry's commercial interests. The SEC does note, however, that almost 49% of global transaction volume in North American CDS involved one U.S. and one non-U.S. counterparty.[82] In the absence of measures to retain those transactions, it is highly likely that the market would further bifurcate and push much of that 49% of the market to non-U.S. counterparties. This, in turn, would limit SEC oversight, increase costs for U.S. counterparties, diminish market liquidity, and hurt the overall competitiveness of the U.S. capital markets relative to overseas markets.

Finally, the SEC fails to acknowledge the very real systemic risks arising from reputational concerns. Foreign affiliates of U.S. persons, especially large global dealing enterprises, can affect the solvency of U.S. affiliates and thereby impose risks to the U.S. financial system, even in the absence of financial arrangements and guarantees. As was seen in the case of Bear Stearns Asset Management and Citigroup's bankruptcy-remote funds and structured investment vehicles ("SIVs"), among others, the pressure to rescue non-U.S. affiliates and SIVs that find themselves in financial trouble on account of less regulated activities can be immense, if not inescapable. Even more problematic, the pressure on U.S. regulators to provide extraordinary financial assistance to non-U.S. entities posing risks to regulated U.S. affiliates may be equally inescapable, as policymakers are certain to seek to contain damage and contagion wherever possible. This is, again, the financial industry seeking a "head-we-win, tails-you-lose" proposition for the U.S. taxpayers and the U.S. financial system, and the SEC must—again—reject it.

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[81] Securities and Exchange Commission, Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8598, 8617 (Feb. 19, 2016).

[82] See Securities and Exchange Commission, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206, 24249 (May 24, 2019).

For these reasons, and others, the SEC itself has repeatedly acknowledged the clear statutory mandate that Title VII of the Dodd-Frank Act applies to all SB-Swap dealing activities occurring in the territorial U.S. and that the "location of risk" arising from such transactions is not dispositive. As the SEC itself described in the de minimis release adopted only a little more than three years ago, many dealers "transact extensively with counterparties established or located in other jurisdictions and, in doing so, may conduct sales and trading activity in one jurisdiction and book the resulting transactions in another."[83] The SEC rightly explained its view then, and in previous proposals, "that dealing activity carried out by a non-U.S. person through a branch, office, affiliate, or agent acting on its behalf in the United States may raise concerns that Title VII addresses, even if a significant proportion—or all—of those transactions involve non-U.S.-person counterparties."[84] There is no new information—and there is certainly none disclosed in the proposal—that fundamentally changes that observation.

IV. Conclusion

The SEC's framework for regulating the SB-Swaps markets must be designed with the international reach of the SB-Swaps markets foremost in mind. Each of the multiple financial stability, market integrity, and counterparty protection objectives of the Dodd-Frank Act requires SB-Swaps regulations that, in some measure, transcend national boundaries. If U.S. financial reforms do not reach far enough, ***U.S. banks*** will simply structure U.S. SB-Swaps, trading desks, and trading activities in clever ways and ultimately book the transactions elsewhere—perhaps with no more than a keystroke—to avoid U.S. regulation, while still exposing U.S. financial system and U.S.-taxpayers to the risks arising from such activities. Similarly—and especially relevant with respect to Market Color guidance—a failure to properly regulate activities by ***foreign banks*** within the U.S. will incentivize foreign banks to conduct extensive trading activity through U.S.-located personnel, also resulting in evasion or avoidance, a loss of transparency, and perhaps competitive disadvantages for U.S. firms.

There is much at stake in proper regulation of the SB-Swaps markets, both for the derivatives industry and the public. Nevertheless, the profits and private interests of the derivatives industry must be subordinated to the public interest. As the SEC considers the cross-border application of the Dodd-Frank Act's derivatives reforms generally and comments on the Market Color guidance specifically, it must view industry comments with due skepticism, given the vast resources deployed to provide self-interested commentary. As emphasized in the bi-partisan Financial Crisis Inquiry Commission's report, in the very recent past, U.S. regulators too often have been accepting of unsupported industry assertions and sometimes, a philosophy that markets are best left to self-regulate, which as we have seen, too frequently and repeatedly comes with devastating consequences:

> We conclude widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets. **The sentries were**

[83] Securities and Exchange Commission, Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 Fed. Reg. 8599 (Feb. 19, 2016), available at https://www.govinfo.gov/content/pkg/FR-2016-02-19/pdf/2016-03178.pdf.

[84] Id. at 8600. See also infra fn. 60.

not at their posts, in no small part due to the widely accepted faith in the self-correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe. **This approach had opened up gaps in oversight of critical areas with trillions of dollars at risk, such as the shadow banking system and over-the-counter derivatives markets** . . .

. . . Yet we do not accept the view that regulators lacked the power to protect the financial system. **They had ample power in many arenas and they chose not to use it** . . . In case after case after case, regulators continued to rate the institutions they oversaw as safe and sound even in the face of mounting troubles, often downgrading them just before their collapse. And where regulators lacked authority, they could have sought it. **Too often, they lacked the political will—in a political and ideological environment that constrained it—as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee.**

Changes in the regulatory system occurred in many instances as financial markets evolved. But as the report will show, the financial industry itself played a key role in weakening regulatory constraints on institutions, markets, and products. It did not surprise the Commission that an industry of such wealth and power would exert pressure on policy makers and regulators. From 1998 to 2008, the financial sector expended $2.7 billion in reported federal lobbying expenses; individuals and political action committees in the sector made more than $1 billion in campaign contributions. **What troubled us was the extent to which the nation was deprived of the necessary strength and independence of the oversight necessary to safeguard financial stability** . . .

. . . we clearly believe the crisis was a result of human mistakes, misjudgments, and misdeeds that resulted in systemic failures for which our nation has paid dearly. As you read this report, you will see that specific firms and individuals acted irresponsibly. Yet a crisis of this magnitude cannot be the work of a few bad actors, and such was not the case here. At the same time, the breadth of this crisis does not mean that "everyone is at fault"; many firms and individuals did not participate in the excesses that spawned disaster. **We do place special responsibility with the public leaders charged with protecting our financial system, those entrusted to run our regulatory agencies, and the chief executives of companies whose failures drove us to crisis. These individuals sought and accepted positions of significant responsibility and obligation. Tone at the top does matter and, in this instance, we were let down.**

No one said "no."[85]

We cite this as a reminder of the recent past and the critical issues at stake. **The sentries at the SEC remain at their post.** But they must remain mindful of the assumptions about the operations of the markets and the motives and incentives of those requesting changes to regulations that have the potential to frustrate if not defeat the Exchange Act's critical statutory objectives.

Sincerely,

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85 Financial Crisis Inquiry Commission, Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States, xxiii (January 2011).