July 13, 2015

Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: 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

To Whom It May Concern:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Securities and Exchange Commission ("Commission").[2] The Proposed Rules would amend the Commission's earlier proposal on the cross-border application of the Commission's security-based swaps ("SBS") regulatory regime, primarily to address situations where two non-U.S. persons engage in SBS transactions that are arranged, negotiated, or executed by their personnel located in a U.S. branch or office ("U.S./Foreign Personnel Activity").[3] The Proposed Rules are part of the implementation of the new derivatives regulatory framework established under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

Although the Proposed Rules apply some elements of the Title VII regime to U.S./ Foreign Personnel Activity in an appropriate way, they are flawed in an important respect: they would exempt those SBS transactions from both clearing and trade execution requirements, two of the foundational reforms in the entire SBS regulatory framework.

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 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*, 80 Fed. Reg. 27444 (May 13, 2015), *henceforth* "Release."

3 *See, e.g.,* Securities and Exchange Commission, *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rule and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, 78 Fed. Reg. 30968 (May 23, 2013).

INTRODUCTION

The SBS marketplace is a thoroughly international one, and the new framework for regulating it must be designed with this characteristic foremost in mind. The new regulatory regime set forth in the Dodd-Frank Act is intended to achieve multiple goals, all of which transcend international boundaries. First and foremost, counterparty credit risk—and by extension, systemic risk—knows no national borders. The danger of ineffectively regulating cross-border SBS activity is vividly illustrated in the still-recent collapse, near-collapse, and massive losses experienced by innumerable banks and nonbanks engaged in derivatives trading across international boundaries during the financial crisis of 2008. These examples are found not only in the lead-up to the crisis, but in much more recent history as well, including the $6 billion loss sustained by JPMorgan Chase's London Whale as a result of derivatives trading conducted out of a London office.

The other goals of the new derivatives regime also transcend international boundaries: regulatory transparency and oversight, liquidity, competitive pricing, a level playing field for market participants, and fair dealing and good faith in all SBS transactions. To achieve all of these ends—including above all preventing another financial crisis—the U.S. regime for regulating derivatives must be applied rigorously to all transactions, whether domestic or cross-border.

If the approach is not comprehensive with respect to SBS transactions that take place either in the U.S. or abroad, the dangers are clear. If the reforms do not reach far enough overseas, then U.S. banks will simply teleport their U.S. SBS transactions overseas—often with no more than a keystroke—to avoid U.S. regulation, while still exposing U.S. taxpayers to the risk of loss. Similarly—and especially relevant with respect to the Proposed Rules—a failure to properly regulate activity by foreign banks **within** the U.S. will incentivize foreign banks to conduct extensive trading activity via personnel here, also resulting in evasion, a loss of transparency, and competitive disadvantages for U.S. firms conducting SBS business.

The SEC must use its authority to regulate cross-border SBS activity to the maximum extent possible to prevent these undesirable, anti-competitive, and systemically dangerous outcomes.

SUMMARY OF COMMENTS

We strongly oppose the Commission's decision to exclude the U.S./Foreign Personnel Activity from the clearing and trade execution requirements. Central clearing and open centralized trade execution of derivatives transactions were among the most fundamental goals of the Dodd-Frank Act. They are critically important in ensuring the SBS market is effectively regulated for the benefit of the markets, market participants, and the economy. The Commission's proposal to exclude from these critical requirements an entire category of trades conducted domestically is unjustifiable.

Those trades exempted in the proposal create risks that could affect the U.S., and the Commission's proffered explanation—that bank capital and margin requirements are sufficient to address those risks—is insufficient. Moreover, allowing foreign firms to trade outside the scope of the rules significantly incentivizes market fragmentation, puts U.S. firms at a significant disadvantage when trading domestically, and creates a bifurcated marketplace.

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Moreover, the Commission should strengthen its proposal by requiring that if **either** non-U.S. counterparty uses U.S.-based personnel, then the transaction must be included within U.S./Foreign Personnel Activity.

OVERVIEW OF THE PROPOSED RULES

The primary purpose of the Proposed Rules is to clarify the regulatory provisions under Title VII that will apply to U.S./Foreign Personnel Activity. The Proposed Rules would:

- require non-U.S. persons to count U.S./Foreign Personnel Activity toward the *de minimis* threshold for determining whether they must register as dealers;
- apply the regulatory reporting and public dissemination requirements to U.S./Foreign Personnel Activity; and
- apply the business conduct standards to U.S./Foreign Personnel Activity.

However, overshadowing all of these positive provisions, the Proposed Rules would inappropriately **exempt** U.S./Foreign Personnel Activity from the clearing and trade execution requirements under Title VII.

COMMENTS ON THE PROPOSED RULE

I. The Clearing and Trade Execution Requirements Must Be Applied to Trading Activity on U.S. Shores Involving Personnel of Non-U.S. Persons.

We strongly oppose the Commission's decision to exclude U.S./Foreign Personnel Activity from the clearing and trade execution requirements.

A. Clearing and trade execution are essential for risk mitigation and fair and transparent markets.

Central clearing and open trading of derivatives were among the most fundamental goals of the Dodd-Frank Act. Central clearing of derivatives is a crucial first line of defense in reducing systemic risk. And centralized, open, electronic platform trading combats the cloistered, opaque, and anti-competitive structure of the dealer-centric OTC markets that ushered in the last crisis. These twin requirements are vitally important in ensuring that the SBS market is effectively regulated for the safety of the market, all market participants, and ultimately the economy. The Commission's proposal to exclude an entire category of trades conducted domestically from these critical requirements cannot be justified.

B. An effective clearing regime depends on broad participation.

In many ways, the benefits of central clearing are similar to those of a vaccination program: They are both most effective when the greatest possible number of people participate. The counterparties that are legitimately excluded from clearing, such as small end-users, are nonetheless protected as long as the vast majority of market participants—and dealers in particular—are mitigating their systemic risk through central clearing. In short, clearing is a mechanism that is as valuable to the broader financial system as it is to each individual counterparty in the system, and exceptions to this requirement should be given only for the most compelling reasons and under the most extreme circumstances.

C. The Commission concedes the need for clearing as a risk mitigant; moreover, capital and margin requirements are no substitute.

In the Release, the Commission relies primarily upon a risk analysis to justify the exemption, yet it concedes that the U.S./Foreign Personnel Activity **does** pose risk to the U.S. The Release states that

> "the non-U.S. person's security-based swap exposures may pose risk to its U.S. affiliates in the United States, as U.S. entities that are affiliated with non-U.S. persons may determine for reputational reasons that they must support their non-U.S. affiliates at times of crisis."[4]

In fact, this scenario came to fruition in the financial crisis, when "many banks did effectively guarantee their SPVs,"[5] and "funding pressure was . . . transmitted to major banks that had sponsored or provided funding guarantees to vehicles."[6]

The Commission's other justification is also unavailing. While the Commission writes that "Congress has established other regulatory tools that are specifically intended" to address such risks, those other tools—namely capital and margin—are simply not substitutes for a strong clearing regime. Congress obviously did not regard margin and capital requirements—either for bank holding companies or for SBS dealers—as interchangeable substitutes. On the contrary, both sets of reforms were included in Dodd-Frank to address important concerns.

D. The trade execution requirement should also apply to U.S./Foreign Personnel Activity.

Allowing foreign firms to conduct trading activity in the U.S. without compliance with the rules on trade execution significantly incentivizes market fragmentation and puts U.S. firms at a significant disadvantage when trading domestically. As envisioned by the Dodd-Frank Act, such a transaction would be straightforward and occur in much the same way that trading occurs in the equities or futures markets. There would be a central marketplace or marketplaces where a counterparty from any location could come to transact anonymously, with prices reported promptly to both regulators and the public, and where any trade ultimately would face only a central counterparty. This is an obvious and time-tested system for operating markets, and it has served well for many years. In general, the Commission has a long way to go before this type of transparent and efficient marketplace is available for SBS trading. The Proposed Rules will further undermine the already lagging effort to reach that goal.

For example, consider the trading of a U.S. swap—for example, a 5yr credit default swap contract referencing a U.S. Corporation. A non-U.S. firm seeking to trade would have to call the relevant dealers (most or all of which are likely U.S. dealer banks or U.S. branches

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4 Release at 27482.

5 Gary B. Gorton, THE MAZE OF BANKING: HISTORY, THEORY, CRISIS 32, Oxford University Press (2015).

6 Ben S. Bernanke, *Causes of the Recent Financial and Economic Crisis,* Speech before the Financial Crisis Inquiry Commission (Sept. 2, 2010), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm.

of foreign dealer banks), collect price quotes, and transact at the best offered price. This system is deeply flawed and far from ideal, as it effectively excludes any firm outside the handful of legacy dealer banks from providing liquidity.[7] It is, however, at least a level playing field amongst those dealer banks. In other words, it is an unfortunately two-tiered system, but at least it is *only* a 2-tiered system.

Under the Proposed Rules, that same non-U.S. firm will have to approach the market in two different ways: It will look for prices on cleared SBS provided by U.S. firms on the Security Based Swap Execution Facilities ("SBSEFs"), and will separately approach the non-U.S. dealers—which also are operating in the U.S.—for bilateral prices. The bilateral trades will not incorporate the costs of clearing or SBSEF trading into their prices, which will allow for different and likely more attractive pricing. The market for this CDS will have effectively been bifurcated. There are two distinct and competing versions of the same product. Non-U.S. firms, if trading on price alone, will likely always find it more attractive to trade with the U.S. branches of foreign banks rather than U.S. person dealers. The Proposed Rules will result in fragmenting the SBS market, and then making U.S. dealers unnecessarily uncompetitive in some of those fragments. None of the Commission's objectives are served by such a situation.

The Commission has deemed these trades between foreign firms conducted in the U.S. to be sufficiently important to U.S. markets that they should be subject to many of the Dodd-Frank Act requirements, such as reporting and business conduct standards, but somehow *not* sufficiently important to be subject to two of the other most important provisions of the law—clearing and execution. The Proposed Rules are thus inconsistent in approach, as well as needlessly harmful to the SBS markets.

E. <u>Cost is not a valid reason for the exemption.</u>

It is true that the requirements to centrally clear SBS trades and conduct them on SBSEFs will impose costs on market participants, and accordingly they have received loud and vehement opposition from the industry. These costs, however, must be viewed in context. Broad and consistent central clearing of swaps would have—in all meaningful ways—prevented the counterparty credit scare and capitulation that ultimately caused the failure of AIG and Lehman Brothers in 2008. The small transaction costs and modest increases in required margin and capital associated with central clearing are essentially meaningless in comparison to the costs that would arise from another credit crisis.

F. <u>Monitoring is no substitute for effective regulation pending the collection of further data.</u>

While the Commission explains that it "expects that Commission staff will monitor developments in the security-based swap market . . . that may warrant reconsideration of this proposed approach," that is no comfort. Not only does this "watchful" attitude implicitly acknowledge the flaws inherent in the decision not to impose clearing and execution requirements on U.S. trading activity, it reverses the Commission's most basic priorities:[8] meaningful market reforms and investor protections first and foremost. If there is any

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7 The Commission itself concedes that the trade execution exemption "may indirectly affect liquidity available to market participants subject to mandatory trade execution." Release at 27482.

8 Release at 27482.

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lingering uncertainty about the optimal approach, the Commission should adopt the one that most effectively achieves the statutory objectives, and thereafter consider whether any adjustments become necessary.

II. The Definition of Transactions Conducted Within the United States Should Be Expanded.

The Commission is formulating the concept of a "transaction conducted within the United States" to include trades by non-U.S. persons, in connection with dealing activity, that are arranged, negotiated, or executed by their personnel in the U.S. The Commission should ensure that this standard is more robustly applied such that personnel in the U.S. acting on behalf of **either** non-U.S. person should be sufficient to trigger application of Title VII.

It is important that if **either** non-U.S. person counterparty uses U.S.-based personnel to arrange, negotiate, or execute a transaction, that trade should be considered within the United States, and for example, included in the *de minimis* calculation for both parties. Title VII applies to any person engaging in SBS transactions within the jurisdiction of the U.S. **and** to any person without the jurisdiction of the U.S. as the SEC determines necessary or appropriate to prevent evasion of Title VII. Both of these jurisdictional tests can and must be applied broadly to ensure that the Title VII framework is not rendered largely meaningless. Consistent with Supreme Court precedent,[9] persons transacting SBS business on domestic platforms **or** persons transacting SBS business where any aspect occurs within the U.S. or with U.S. Persons, are within U.S. jurisdiction. Thus, the involvement of personnel within the United States acting on behalf of just one non-U.S. person in the U.S./Foreign Personnel Activity scenario warrants application of the Title VII protections.

Nothing in this requirement would place a significant new burden on firms. Non-U.S. Persons that engage in dealing activity with other non-U.S. Persons can reasonably be required to consider the location of their counterparty's dealing activity (whether the personnel are located in the U.S. or abroad) in addition to the location of their own activity. In fact, traders are generally aware of the location of their counterparties' front office personnel, and if necessary, making this determination would be as simple as asking the counterparty's location at the beginning of each transaction.

Thus, based on the legal scope of the Commission's jurisdiction, the policy objectives underlying Title VII, and even pragmatic implementation concerns, this interpretation of transaction "conducted within the United States" is appropriate, necessary, and feasible.

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[9] *Cf. Morrison v. Nat'l Austl. Bank Ltd.,* 130 S. Ct. 2869, 2888 (2010) (finding U.S. jurisdiction lacking in a case that "involve[d] no securities listed on a domestic exchange, and all aspects of the purchases complained of . . . occurred outside the United States.").

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CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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