Stopping Wall Street's Derivatives Dealers Club

Why The CFTC Must Act Now To Prevent Attempts To Undermine Derivatives Trading Reforms That Threaten Systematic Stability and Harm Consumers

By Dennis Kelleher, Caitlin Kline and Victoria Daka

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Introduction

Seven years after the worst financial crisis since the Great Crash of 1929, too many critical and essential reforms of the derivatives markets have come to a halt. The CFTC, the primary regulator of the derivatives markets, is at a cross roads. Either it will preside over the slow demise of these reforms or it will take action - now - to get reform back on track, get the markets working as intended, and protect America from another derivatives-fueled crisis.

Two recent lawsuits, one of which settled for nearly $2 billion dollars[2], have highlighted and confirmed how these reforms have been killed in the marketplace by the practices of the derivatives dealer club and its enablers. Numerous formal and informal means of market control and dominance have been used to defeat reform. While it is clear the club would do this to protect their business lines, revenue and bonuses, the CFTC's lack of action to protect the swap market is inexplicable and must change.

Today, just four Wall Street dealers - the broker arms of the largest banks on Wall Street that intermediate client trading - still control more than 90% of the U.S. derivatives markets, which have a notional value of almost $200 trillion[3]. While this market dominance is extremely profitable for those four Wall Street firms,[4] that concentration of market power presents a serious threat to systemic stability, as was plainly visible during the 2008 financial crash.

Derivatives played a uniquely destructive role in the 2008 financial crash. Derivatives generally, and swaps in particular, accelerated the crash and acted as a conveyor belt, spreading the crisis throughout the global financial system.[5] As a result, Congress enacted Wall Street reforms in 2010 that aimed to bring increased transparency to the swaps market, create a level playing field, enable comptetition, and reduce systemic risk. A primary target

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[1] *See*, The Brookings Institution, "The Derivatives Dealers' Club and Derivatives Markets Reform: A Guide for Policy Makers, Citizens and Other Interested Parties," (April 10, 2010), *available* at http://www.brookings.edu/~/media/research/files/papers/2010/4/07%20derivatives%20litan/0407_derivatives_litan.pdf.

[2] See, Jesse Drucker, "Wall Street Banks to Settle CDS Lawsuit for $1.87 Billion," Bloomberg (September 11, 2015), *available* at http://www.bloomberg.com/news/articles/2015-09-11/wall-street-banks-reach-settlement-on-cds-lawsuit-lawyer-says.

[3] See, OCC, "Quarterly Report on Bank Trading and Derivatives Activities for Third Quarter 2015," *available* at http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq315.pdf. Of note, the OCC's Quarterly Report on Bank Trading and Derivatives shows JP Morgan Chase, Citibank, Goldman Sachs, and Bank of America hold 91% of the total $191 in derivatives market.

[4] According to the OCC, in 2014 trading revenue for insured U.S. commercial banks and savings associations totaled $22.7 billion, $0.6 billion higher thanin 2013, led by a $0.3 billion increase in commodity and other revenue. *Id at* 1.

[5] *See*, e.g., Shanuka Senarath , "Credit Default Swaps and the Global Financial Crisis: Reframing Credit Default Swaps as Quasi-Insurance," (August 12, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2479733.

of these reforms were the marketplaces in which swaps historically traded, which suffered from extreme opacity under the anti-competitive control of a handful of the world's largest dealers.

That is why, in the Dodd-Frank Act, Congress mandated that most swaps trade on open and competitive platforms, as other products like futures and equities have done for decades. A key feature of these newly created exchange-like platforms, called "swap execution facilities," or "SEFs", was the requirement that they be open and offer impartial access to ensure that all market participants may join and trade on a level playing field at the best prices. These reforms were intended to end the large dealers' oligopolistic control over the swaps market and introduce greater competition and pre-trade price transparency, ultimately strengthening the swaps marketplace, reducing systemic risk and lowering costs for all market participants in the process.

However, more than five years after the Dodd-Frank Act was signed into law, and despite new rules, little in these markets has changed in practice. While SEFs were created and registered with the CFTC in 2013, the swaps market continues to operate much like it did pre-Dodd-Frank Act: a few large dealers have preserved their exclusive "dealer-only" markets to which other market participants are denied access by evading the SEF trading requirement, and by pressuring certain SEFs to maintain barriers that prevent non-dealers from joining.[6] These incumbent dealers use both formal and informal methods of control to not only perpetuate their market dominance, but also to embed the unacceptable risk caused by opacity, limited price discovery, and concentrated liquidity provision.[7]

As a result, U.S. market participants have been relegated to a small handful of SEFs that require them to trade largely as they did prior to the Dodd-Frank reforms. Specifically, they must approach individual large dealer banks for a price quote on a fully disclosed basis, thereby giving the banks invaluable information about how they want to trade without gaining the transparency or access to the prices available on dealer-only trading venues. In summary, the incumbent dealers have created a bifurcated, two-tiered market that entrenches pre-crisis practices: a dealer-to-dealer tier and a dealer-to-customer tier. Ultimately, this enables a handful of dealers and their allies to perpetuate their longstanding market dominance.

This is precisely the situation the Dodd-Frank Act and the SEF mandate were intended to prevent.

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[6] *See*, *In Re Credit Default Swaps Antitrust Litigation*, U.S. District Court SDNY (Oct. 16, 2015) and Public School Teachers' Pension and Retirement Fund of Chicago v. Bank of America Corporation et al, Docket No.1:15-cv-09319 (S.D.N.Y. Nov 25, 2015).

[7] *See generally*, Better Markets Comment Letters "Core Principles and Other Requirements for Swap Execution Facilities," (March 8, 2011), *available* at https://www.bettermarkets.com/sites/default/files/documents/CFTC-%20Comment%20Letter-%20SEF%20Core%20principles%203-8-11.pdf; and "Conflicts of Interest for Swap Exectuion Facilities, Designated Contract Markets, and Derivatives Clearing Organizations," (August 26, 2011), *available* at https://www.bettermarkets.com/sites/default/files/documents/CFTC-%20Supplemental%20CL-%20Conflicts%20of%20Interest%20SEFs%2C%20DCOs-%208-26-11.pdf.

Thus, there is still a great deal of work to be done given the ongoing anti-competitive structure and practices in the markets. Supporters of the current market structure claim that the dealer market dominance is a natural condition of the markets, which, they claim, will evolve "organically" if and when appropriate. However, this "invisible hand" myth is inapplicable to the swaps market, and only entrenches incumbent dealers and protect their profits by killing competition and evading or violating the rules and the law.

Such claims of natural evolution would only be valid in a market that is genuinely transparent and competitive, and free of evasion, collusion, and artificial restraints. Unfortunately, this is far from reality in today's swaps market.

The law requires swift and meaningful action by the CFTC to break open these derivatives markets, to stop the undue influence of the derivatives dealers club, and to protect taxpayers from systemic risk. To attain this end, the CFTC must:

- **End the free pass provided to swap traders located in the U.S. -** The CFTC should immediately regulate all derivatives activitites within the United States – and impose its existing rules, ceasing the continuous no-action relief to the dealers.

- **Enforce CFTC rules on impartial access and eliminate post-trade name disclosure on SEFs -** The CFTC's clear impartial access rules applicable to SEFs must be actually enforced, including an active prohibition on all practices designed to preserve prohibited dealer-only platforms, such as the harmful legacy practice of post-trade name disclosure.

- **Promote harmonization with global regulators to eliminate regulatory arbitrage -** U.S. regulators must promote harmonization with global regulators and ensure substituted compliance isn't granted unless U.S. core principles, including impartial access, are implemented in an equivalent manner.

- **Establish policies to ensure transparency regarding the derivatives activities of de-guaranteed affiliates -** U.S. regulators have the obligation to understand how U.S. financial reforms may be undermined by the act of de-guaranteeing, and act to limit evasion.

A Brief History of the Swaps Markets

Until the mid-2000s, the swap market was a highly customized ("bespoke") and cloistered marketplace. Each trade was structured as its own unique contract with few standardized features, and was almost exclusively provided by one of a few dealers, which had large balance sheets and risk appetites that allowed them to take on such illiquid and custom-built risks. As the market developed, it adopted a structure resembling the institutional bond market, where a handful of dealers conducted trades with the buy side, and offset the risk of those trades between each other in a separate, closed interdealer exchange facilitated by interdealer brokers. Because each swap was ultimately a bilateral contract, all traders were

necessarily told the identity of their counterparties immediately after the trade was completed. In those days, knowing your counterparty was crucial to manage counterparty risk, net exposures, and exchange margin and interest payments.

As the market for swaps grew up and modern risk-management tools developed, various efforts were made to standardize the products and simplify the transactions. Standard payment dates and fixed coupons, particularly in the CDS market, did much to increase the fungibility, and thereby liquidity of the products. Most importantly, the increase in central clearing of swaps all but eliminated the need to manage a variety of counterparty exposures – or to even know the identity of the trading counterparty at all. Cleared trades always face a central clearinghouse, regardless of which counterparties initially engaged in the trade.

As a result, swaps, in all applicable ways, became a market ripe for centralized open exchange trading – and indeed many attempts to introduce swap exchanges were made over the years.[8] Importantly, by this time, there were no structural or technological reasons that the swap market would be unsuitable for exchange trading. In fact, the dealers had already developed and relied on exchange platforms for years, in the form of "broker screens" facilitated by the interdealer brokers. However, these private dealer exchanges were closed to all except a handful of dealer members who used the exclusivity to guard their profitable business of liquidity provision.

One of the worst-kept secrets in the derivatives markets was the not-so-subtle manner in which the swap dealers put significant pressure on interdealer brokers to maintain limited access to the broker screens on which they relied so heavily. The mechanics of this behavior is detailed in the complaint filed by swaps investors in their case against the anti-competitive behavior of dealer banks from 2008 through current day.[9] Specifically, the complaint illustrates how for many years the large dealers created, maintained and forced upon market participants, the existing two-tiered dealer-to-dealer and dealer-to-customer marketplace – to their great disadvantage. Notably, these are the same large dealers now maneuvering to maintain this anti-competitive structure in a SEF-based world. Meanwhile, SEFs were specifically designed and intended to provide a significant and necessary remedy for these anti-competitive private interdealer markets.

What is particularly important about the behavior described in the lawsuit is that it directly contradicts the baseless claims that the bifurcation of the swaps marketplace into a dealer-to-dealer and dealer-to-customer structure is somehow a natural and necessary market structure that exists to serve the unique needs of the swap market participants. While dealers defending the status quo often make this argument, it is categorically untrue. Rather, other liquidity providers (sell-side or otherwise) would have readily entered into the

[8] *See*, Joe Rennison, "Meet the new OTC market-makers," Risk.net (February 27, 2014), *available* at http://www.risk.net/risk-magazine/feature/2331122/meet-the-new-otc-market-makers.

[9] *See generally*, *In Re Credit Default Swaps Antitrust Litigation*, U.S. District Court SDNY (Oct. 16, 2015) and Public School Teachers' Pension and Retirement Fund of Chicago v. Bank of America Corporation et al, Docket No.1:15-cv-09319 (S.D.N.Y. Nov 25, 2015).

business of market-making for credit default swaps were it not for the significant market power concentrated in the largest swap dealers and their facilitating inter-dealer brokers.[10]

In a free market populated by competitive, profit-maximizing dealers and price conscious customers, it would not make sense to expect otherwise. The margins from making markets in such a liquid marketplace with still sizable bid/offers spreads to capture would surely be attractive to many market participants outside the few traditional incumbent swaps dealers. As risk-reduction mechanisms, such as netting, compression, and clearing, became easier and more prevalent, the attendant counterparty risks and balance sheet usage declined sharply year after year, further reducing barriers to entry. There is no question that other derivatives market participants wanted to be dealers in this market, and were actively – seemingly unlawfully - kept out.[11]

The Dodd-Frank Trading Reforms and Initial Dealer Pushback

Congress required in the Dodd-Frank Act that most pre-crash dark trading of derivatives (so-called "OTC" for the opaque, customized "over the counter" market) be moved to transparent SEF trading platforms. Congress also required these SEFs to be open and competitive to all market participants by including an impartial access requirement in the final legislation.[12] This was intended to allow and encourage any market participant to have access to, and the ability to, trade on any execution venue. This would result in sparking competition and increasing price transparency.

In response to questions from the large dealers about what was specifically meant by 'impartial access,' the CFTC clarified in its final rules issued in June 2013. More specifically, the final rules indicated that dealers were not permitted to maintain the old market structure by restricting access to some SEFs to maintain them as dealer-only trading venues.[13] However, this did not stop those dealers from attempting to do just that through less overt

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[10] See, for example, Duncan Wood, "Profile: Citadel's Hamill on the fight for swaps market share," Risk.net (March 30, 2015), *available* at http://www.risk.net/risk-magazine/profile/2400949/profile-citadels-hamill-on-the-fight-for-swaps-market-share. [**See also** http://constantinecannon.com/antitrusttoday/2013/06/04/credit-default-swap-purchasers-accuse-bankers-of-blocking-competition/; http://www.wsj.com/articles/bluemountain-citadel-pimco-dtcc-subpoenaed-in-credit-swaps-lawsuit-1435090212; http://www.risk.net/risk-magazine/news/2436585/banks-held-back-e-trading-for-swaps-new-lawsuit-alleges; http://europa.eu/rapid/press-release_IP-11-509_en.htm] Similarly, attempts to introduce exchange trading in the bond markets have been stymied for decades. For example, a 2003 lawsuit alleges the same anti-competitive practices by dealer banks as far back as 1997. *See, Intervest v. Bloomberg*, 340 F.3d 144, 2003 U.S. App. LEXIS 16423, at *26 (3d. Cir. 2003).

[10] Section 5h(f)(2)(B)(i) of the Commodity Exchange Act.

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[12] Section 5h(f)(2)(B)(i) of the Commodity Exchange Act.

[13] Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33476 (June 4, 2013) at 33508.

ways. For instance, dealers pressured SEFs to adopt internal rules that served to prevent non-dealer banks from competing as liquidity providers on the platform.[14]

As a result, the CFTC was forced to issue further additional guidance in November 2013. This guidance specifically prohibited these practices and again stressed that the Dodd-Frank trading reforms require all market participants to be allowed to compete on a level playing field with respect to access to SEFs.[15]

The stranglehold the dealers have put in place to prevent the swaps market from evolving and becoming more transparent and competitive has caused market participants to incur significantly higher costs. A recently settled lawsuit by several institutional investors against many of the big dealer banks and the International Swaps and Derivatives Association (ISDA) provided support of this effect. In the complaint, the plaintiffs, among other things, alleged:

> "acting jointly and in concert, [Defendant dealers] undertook a series of anticompetitive actions that prevented all but a handful of the world's largest banks from acting as dealers and clearing members in the multi-trillion dollar market for [credit default swaps (CDS)]."[16]

The parties in this litigation recently agreed to a settlement requiring the defendant dealers to pay nearly $2 billion and engage in other remedial actions intended to increase competition in the market. A similar suit alleging the same collusion and conspiracy in the Interest Rate Swap market has just recently been filed.[17]

While we applaud the plaintiffs for seeking to hold the dealer banks accountable for their efforts to improperly preserve control over the lucrative swaps markets, there is clearly still a great deal of work to be done given the ongoing anti-competitive structure and practices in the markets. The controlling dealer banks claim that their market dominance is a natural condition of the markets, which, they claim, will naturally evolve as appropriate for each market. However, such wildly anticompetitive and structurally imbalanced marketplaces simply cannot support fair and natural development.[18]

Nevertheless, with tens of billions of dollars in profits from their inordinate control of trading at stake, the dealers have continued their efforts to avoid the clear statutory mandate for an

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[14] See, Peter Madigan, "Bloomberg, MarketAxess, Tradeweb not complying with Sef rules – Gensler," Risk.net (November 19, 2013), *available* at http://www.risk.net/risk-magazine/news/2307755/bloomberg-marketaxess-tradeweb-not-complying-with-sef-rules-gensler.

[15] *See*, CFTC, Staff Guidance on Swap Execution Facilities Impartial Access (November 14, 2013) at page 4, *available* at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/dmostaffguidance111413.pdf.

[16] *See*, *In Re Credit Default Swaps Antitrust Litigation*, U.S. District Court SDNY (Oct. 16, 2015).

[17] *See*, Public School Teachers' Pension and Retirement Fund of Chicago v. Bank of America Corporation et al, Docket No.1:15-cv-09319 (S.D.N.Y. Nov 25, 2015).

[18] In 2015, Commissioner Giancarlo released a "white paper" on swap market structure, arguing that markets evolve naturally to the structure that best suits them, and discouraging intervention by regulators. The substantive claims of this white paper were discredited to a significant extent by these lawsuits.

open, impartial, and transparent marketplace through broad-based, tactical, and technical evasions. A partial list of these efforts is discussed below.

Cross-Border Evasion

Faced with the additional CFTC guidance around the impartial access mandate and the impending start of the mandatory SEF trading requirement in February 2014, the large dealers started to focus on another strategy to supplement their approach in the U.S.: divert as much business away from U.S. SEFs as possible, toward regions where they can preserve the old market structure that they control. With foreign trading rules years away from being finalized, the large dealer banks could still trade on legacy dealer bank-only platforms in Europe - provided they could find ways to do so without triggering the U.S. derivatives rules.[19]

To do this, the dealers focused on two areas, discussed in detail below:

(a) removing in form (but not in substance) U.S. parent guarantees from foreign affiliates to take advantage of a loophole they had been granted by U.S. regulators (so-called "de-guaranteeing") [20], and

(b) convincing the CFTC to exempt traders working in the U.S. from Dodd-Frank rules if they booked the swaps to offshore entities (including some of the same entities they conveniently "de-guaranteed").

Both these actions had the effect of continuing their control of swaps markets by technically offshoring their activity.

(a) De-guaranteeing non-U.S. affiliates

When the Dodd Frank law was passed and when the CFTC's SEF trading rules were finalized, nearly all of the OTC derivatives on the books of U.S. dealers were executed by either a U.S. entity or an entity guaranteed by a U.S. entity. That was due to market participants' demands to reduce credit and counterparty risk. Thus, to ensure that the new rules captured virtually

[19] US dealer banks like Lehman Brothers, Bear Stearns and Citigroup (not to mention non-dealer banks like AIG) shifted much of their trading overseas before the 2008 financial crash, largely to avoid US regulations intended to protect US taxpayers. As was revealed in the financial crash, many of those overseas derivatives activities created, packaged, sold and distributed mountains of worthless derivatives, which created enormous, crippling liabilities for those derivatives dealers, which were bailed out by the US taxpayers. To make sure that never happened again, the Dodd Frank financial reform law explicitly required that US regulations to protect US taxpayers reach all derivatives activities regardless of where they occurred if they could have a "substantial impact" on the US. This is often referred to as the "cross border" requirement that US rules apply to certain derivatives activities that take place outside of the US.

[20] *See*, Better Markets Fact Sheet on De-Guaranteeing, *available at* https://www.bettermarkets.com/sites/default/files/Cross-Border%20Guarantee%20Fact%20Sheet%206-19-14%20(2).pdf.

all of the previously unregulated trading by the dealer banks, the CFTC specifically required all swaps that were booked to a U.S. entity or a U.S.-guaranteed affiliate to be traded on SEFs and subject to other critical Dodd-Frank reforms.

From a systemic risk perspective, it was clear why regulators needed to have visibility into all of these derivatives and wanted them to be traded more transparently. A lengthy list of prior disasters, including Long Term Capital Management in the 1990s, Bear Stearns, Lehman Brothers and AIG Financial Products in 2008, and the "London Whale" in 2012, all demonstrated that transactions conducted through foreign subsidiaries or in foreign jurisdictions have led to significant losses in, or even the failure of, the U.S. parent company.[21]

The large U.S. dealers sought ways to evade the U.S.-guaranteed affiliate SEF requirement, and moved quickly to simply change their contract language to remove the word "guarantee" from one or more of their non-U.S. affiliates. Technically, this placed their non-U.S. affiliates outside of the reach of the CFTC's rules. Of course, history has repeatedly demonstrated that U.S. parent companies will bail out their foreign affiliates with or without the existence of an explicit contractual guarantee, and this fact was well known by their swaps counterparties.

Therefore, the removal of this specific contractual language was a practically meaningless exercise - its sole purpose was regulatory evasion[22]. By appearing to remove the guarantees, the U.S. dealer banks could continue to trade on dealer-only platforms outside of the U.S. through their non-U.S. affiliates (ostensibly now not guaranteed) without triggering the requirement to trade on SEFs. In addition, large dealers continue to prevent market participants from benefitting from those trading platforms.[23]

(b) Exempting traders working in the U.S. from CFTC rules

Along with applying U.S. rules on an entity level, the CFTC SEF rules are also designed to apply on a personnel level. Specifically they applied equally to all traders working in the U.S. regardless of where their trades were ultimately booked. The dealers had used the de-guaranteeing tactic to ensure their foreign trades escaped the SEF mandate, but they also wanted their U.S. trades to be exempt when they were booked into an exempt foreign affiliate (such as those they had conveniently just de-guaranteed). Lacking any obvious loophole to exploit, the banks needed this "personnel" application to be reversed.

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[21] *Id*.

[22] This maneuver was the ultimate form-over-substance regulatory arbitrage. If the now non-guaranteed foreign affiliates were truly not guaranteed by the US parent dealer bank, then the price of dealing with them would have gone up significantly to reflect the increased risk of these very thinly capitalized subsidiaries once they lost the benefit of financial backing of their U.S. parents. However, there was no price differential exhibited after these de-guarantees because they were de facto guaranteed affiliates merely pretending not to be guaranteed. As we have set forth elsewhere, a few relatively simply requirements and a market test would quickly prove that that these entities are in fact guaranteed and, therefore, a violation of the law.

[23] *Id*. In light to of this, we have argued – to no avail – that the CFTC use its anti-evasion authority to stop these practices.

In December 2013, the dealers, via their industry organizations, sued the CFTC to reverse its approach on cross-border regulation.[24] In response, the CFTC granted no-action relief the week prior to the legal challenge being filed that suspended the application of CFTC rules to U.S. traders working on behalf of non-U.S. entities.[25]

The sole basis for this relief was the representation made by the dealers to CFTC staff that additional time was necessary to allow them to "organize their internal policies and procedures to come into compliance" with CFTC rules.[26] However, instead of working to come into compliance, the dealers used the relief to structure their operations to evade the SEF trading requirement. Despite the fact that the dealers lost this judicial challenge,[27] the complete suspension of the CFTC rules continues today, almost two years later - and the CFTC has even recently extended the suspension through 2016.[28] Again, on the sole basis that the dealers requested time to "organize their internal policies and procedures to come into compliance" with CFTC rules, now revealed to be no more than a pretext.

In bowing to the pressure exerted by the dealers, the CFTC's suspension of its own rules has also created harmful precedent that is impacting other reform efforts. For example, the SEC recently proposed to entirely exclude U.S. traders of non-U.S. banks from its trading reforms for credit default swaps.[29] Allowing the dealers to structure their operations to purposefully avoid financial reforms critical to improving transparency and decreasing systemic risk is a massive failure on the part of U.S. derivatives regulators.

Impact of the Cross-Border Evasion

As a result of the actions described above, all of the dealers that historically have dominated the OTC derivatives markets continue to trade derivatives with the same overwhelming control as prior to the Dodd-Frank Act. These dealers use both domestic and foreign traders to transact on dealer-only platforms that the rest of the market cannot access, causing various significant impacts on the swap markets.

(a) Increases Systemic Risk

[24] *See*, Gina Chon, "CFTC sued by trade groups over swaps rules," Financial Times (December 4, 2013), *available* at http://www.ft.com/cms/s/0/0f998b74-5d1a-11e3-a558-00144feabdc0.html#axzz3xjATtvjn.
[25] *See*, CFTC Letter No. 13-71 (November 26, 2013), available at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/13-71.pdf.
[26] *Id*. at 2.
[27] *See*, Andrew Ackerman, "Court Dismisses Lawsuit Against CFTC Over Cross-Border Swaps Rule," Wall Street Journal (September 16, 2014), *available* at http://www.wsj.com/articles/court-dismisses-lawsuit-against-cftc-over-cross-border-swaps-rule-1410886143.
[28] *See*, CFTC Letter 15-48 (August 13, 2015), *available* at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/15-48.pdf.
[29] 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. 27,444 (May 13, 2015).

The de-guaranteeing of foreign affiliates has undermined critical market structure reforms and increased systemic risk for the U.S. economy by allowing derivatives risk to remain concentrated in entities that the U.S. parent will not allow to fail. As highlighted by both regulators and members of Congress,[30] the lack of an explicit, written guarantee of a foreign affiliate does not mean that a U.S. parent company would allow its non-U.S. affiliate to fail in a time of crisis.

To the contrary, history has shown that, due to the severe reputational risk associated with an affiliate failure, a parent company will go to great lengths to bailout its affiliates,[31] In practice, tiered counterparty credit-specific markets have not emerged to reflect market participants' perceived heightened credit risk in de-guaranteed entities. Confirming this, even ratings agencies have largely disregard the relevance of de-guaranteeing for ratings purposes.[32]

For the same reasons, Congress has prohibited banking entities from sharing the same name as a hedge fund for corporate, marketing, promotional, or other purposes[33] and regulators have specifically recognized that a banking entity could come under pressure for reputational reasons to support any entity that bears the banking entity's name.[34]

The idea that a foreign affiliate – explicitly guaranteed or otherwise - does not present risk to its U.S. parent is plainly wrong, contradicted by history and current market evidence. It is broadly understood that, from a market reputational standpoint, a U.S. parent would simply not let a troubled foreign affiliate fail. However, under the current regulatory construct, this cosmetic change in documentation affords such affiliates the ability to largely disregard U.S. reforms when trading OTC derivatives and, thereby, to maintain a two-tiered oligopolistic market.

(b) Negatively Impacts U.S. Investors

The success of large dealers in preserving their ability to trade on dealer-only platforms has also severely undermined U.S. efforts to increase transparency and reduce transaction costs

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[30] *See, e.g.,* Remarks of SEC Commissioner Kara M. Stein on the Cross-Border Security-Based Swap Rules and Guidance (June 25, 2014), *available* at http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542555426 and Letter from Representative Maxine Waters to CFTC Chairman Massad (June 12, 2014), *available* at http://www.cadwalader.com/thecabinet/get_doc.php?id=34245

[31] For example, in 2007 Bear Stearns provided a $1.6 billion bailout to a hedge fund unit even though it was not obliged to. Also, Citigroup assumed $49 billion of liabilities from SIVs it had previously sponsored even though they were structured to be bankruptcy remote and had no legal obligations to do so. See Better Markets comment letter August 27, 2012 *available at* www..bettermarkets.com%2Fsites%2Fdefault%2Ffiles%2FCFTC-%2520CL-%2520Cross%2520Border%2520Application%2520of%2520swaps%2520provisions%25208-27-12.pdf

[32] Fitch Ratings, "U.S. Banks De-Guaranteeing: No Immediate Ratings Impact," Fitch Wire (September 23, 2014), *available* at https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/US-Banks-De-Guaranteeing%3A?pr_id=880074.

[33] *See,* 12 U.S.C. § 1851(d)(1)(G)(vi) (2012).

[34] *See,* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014).

for U.S. investors. The trading reforms were intended to (1) increase pre-trade transparency by enabling *all* market participants to view available prices across the market and (2) lower trading costs through increased competition as new non-bank liquidity providers are allowed to enter the market.

However, as many products such as certain interest rate derivatives are now being predominently traded on foreign dealer-only trading platforms, U.S. market participants, especially end users, are not benefitting from increased transparency or competition in those products. To the contrary, they are forced to continue trading through the same large dealer middle-men in the same way as prior to the financial crisis, while continuing to overpay for swaps transactions.

(c) Threatens Global Reforms

Perhaps most alarmingly, the large dealers use their evasion of U.S. trading reforms as a justification for the need to water-down or repeal these requirements. For example, ISDA has put out multiple research papers alleging that swaps trading has migrated abroad since the SEF trading became mandatory in February 2014, and calling for the CFTC to relax its rules as a remedy.[35] Of course, these studies don't disclose that they are exclusively based on activity between the same large dealers that are using recently de-guaranteed foreign affiliates to evade the SEF trading requirement. The truth behind this self-serving circular logic is that these statistics demonstrate little more than the large dealers' success in evading U.S. rules, which prevents investors from realizing the intended benefits of financial reform. Demonstrating that a regulatory loophole has successfully incentivized evasion simply cannot be a justification for weakening additional important market protections. Indeed, it is a need to strengthen U.S. rules and step up efforts to combat evasion.

In addition, ISDA and the dealers are actively lobbying the CFTC to recognize foreign trading platforms as equivalent to SEFs, even if they don't have the critical impartial access rules that ensure a fair and open marketplace. Such recognition would completely undermine the enacted Dodd-Frank swap trading reforms and codify SEF evasion, as dealers banks would be able to meet the CFTC's requirements by trading on wholly unsatisfactory and sub-standard dealer-only platforms abroad.

It is critical that the CFTC begins to enforce the existing rules, and ensures that only foreign regulatory regimes that are *in fact* equivalent - in form, substance, enforcement, and over time – are allowed to substitute for Dodd-Frank's rules (so-called substituted compliance).

Other Impediments to Open and Competitive SEF Trading

The large dealers are also attempting to preserve certain SEFs as dealer-only, despite the clear statutory impartial access requirement and the additional CFTC guidance. In practice, the law and guidance continue to be violated or evaded at almost every SEF. Due in large

[35] *See*, *e.g.,* "ISDA Research Note: Cross-Border Fragmentation of Global Interest Rate Derivatives: The New Normal?" (October 28, 2015), *available* at http://www2.isda.org/functional-areas/research/research-notes/.

part to the legacy dealer-centric market structure, new SEF platforms simply cannot succeed without the big dealers providing liquidity on them. Effectively, the dealer-to-client SEFs are at the mercy of the existing dealers due to their outsized market power. Moreover, this meaningfully disincentives them from making any changes that may receive retaliation from the biggest dealer banks. As a result, there is little opportunity for "organic" market evolution to occur in such a deeply anti-competitive marketplace.

(a) Formal and informal means of control over trading venues, counterparties and infrastructure

Faced with a statute that threatens their lucrative stranglehold over swaps market-making, dealers focused on their significant market power over trading venues, counterparties and infrastructure to combat any significant change from occurring. The effort has been relentless – sometimes buried in SEF rulebooks and trading workflow minutia, and other times amounting to outright intimidation.

Some of the tactics include (i) denying their clearing customers the credit limits necessary to trade on SEFs that don't acquiesce to the dealers' demands, (ii) ceasing liquidity provision on SEFs that attempt to comply with CFTC impartial access requirements, and (iii) threatening to provide inferior off-SEF pricing to customers that attempt to trade on dealer -only SEFs.[36]

In addition, certain firms are employing overtly prohibitive cost structures to access their dealer-only SEFs. One particular company owns two SEFs: one designed exclusively for dealers, which allows transactions to occur anonymously, at a cost of around $50,000/month; the other is designed for non-dealer market participants and always discloses counterparty identities, at a cost of around $100/month. It would be challenging to find a legitimate rationale for this enormous cost differential between these two platforms operated by the same company. However, it is clear that this cost structure effectively establishes and entrenches a bifurcated dealer-to-dealer and dealer-to-customer

[36] *See*, *e.g.,* Karen Bretell, "Banks' pressure stalls opening of US derivatives trading platform," Reuters (August 27, 2014) ("Several hedge fund managers that had planned to join GFI's credit platform received phone calls from multiple banks that indicated that they would stop trading with them or send them unfavorable pricing if they joined an interdealer venue, people familiar with GFI plans said"), *available* at http://www.reuters.com/article/2014/08/27/usa-derivatives-banks-idUSL1N0QW1T220140827;"Meet the new OTC market-makers," Risk.net (February 27, 2014) ("'In interest rate swaps, we have been given strong signals by our dealers that they would be annoyed if we, as a buy-side firm, showed up in the interdealer platforms,' says one US-based hedge fund manager"), *available* at http://www.risk.net/risk-magazine/feature/2331122/meet-the-new-otc-market-makers; and Joe Rennison, "Bloomberg, MarketAxess, Tradeweb not complying with Sef rules – Gensler," Risk.net (November 19, 2013) ("One example of an engagement mechanism is the breakage agreements that some Sefs had planned to require clients to sign – contracts that lay out steps for counterparties to follow in the event a trade is rejected for clearing, but which buy-side critics said would stop them trading with any more than a handful of dealers. In most cases, these requirements were removed from Sef rule books before an October 2 registration deadline. Another example are rules that only allow swap dealers or clearing members to respond to quote requests.") *available* at http://www.risk.net/risk-magazine/news/2307755/bloomberg-marketaxess-tradeweb-not-complying-with-sef-rules-gensler.

marketplace, while ostensibly complying with the rules. As if to explicitly mock the CFTC's prohibition on dealer-only platforms, the registered name of the $50,000 SEF described above is "Dealerweb".

Collectively, the activity around the evolution of SEFs paints a picture of an oligopoly desperate to protect its immense profits – no matter the spirit, or even the letter, of current laws, rules, and regulations.

(b) Post-trade Name Disclosure

Perhaps the simplest and most effective impediment to wider market participation is the practice of post-trade counterparty disclosure, also known as "name give-up". This refers to the practice of certain SEFs, in particular those operated by the legacy inter-dealer brokers, disclosing the names of the counterparties to each other after execution, despite any practical reason to do so and its significant potential harm to market participants.

As discussed above, centrally clearing swaps eliminates any bilateral relationship between initial trade counterparties, thereby obviating the need to disclose their identities at any time. Indeed, other cleared markets such as equities and bonds do not, nor have they ever, employed post-trade name give up. There simply is no reason to disclose who sold you that stock or bond, and doing so would unnecessarily reveal market information that may benefit some parties over others.

In practice, in a SEF environment, this unnecessary disclosure of swap counterparties only serves to inform the dealers of the non-dealer firms banks that are attempting to trade on their platforms, and inviting retaliation. For example, once a dealer knows that a swaps customer is trading on a dealer-only platform, they can penalize the customer through other channels, such as withhold the extension of credit or provide inferior pricing for off-SEF products. This retaliation against market participants is indeed occurring broadly today and has been well-documented in the press.[37]

In addition, the dealer banks are even overtly punishing the SEFs themselves when they attempt to allow anonymous trading to clients. One SEF, operated by large inter-dealer broker GFI, that attempted to remove post-trade name disclosure on some of its platforms experienced such immediate and significant push bank from the banks that it was forced to change course. Ultimately, it was sold to another interdealer broker.[38]

In April 2015, CFTC Chairman Massad stated, at the ISDA 30th Annual General Meeting, that

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[37] *Id*.

[38] *See,* Katy Burne, "CFTC to Propose Swaps Anonymity," The Wall Street Journal (February 16, 2015) ("When broker GFI Group Inc. began rolling out a new trading system a year ago, officials received heated phone calls from executives at Credit Suisse Group AG and J.P. Morgan Chase, said people familiar with the discussions. The banks' beef: GFI's system kept traders' identities a secret, upending the long-held practice on broker-run swaps platforms, where participants typically disclosed their identities."), *available* at http://www.wsj.com/articles/cftc-to-propose-swaps-anonymity-1424132424.

> "We have heard market participants express concern about potential negative consequences of this practice with respect to its effects on liquidity and participation, and I have not heard a compelling justification for it." [39]

He was and is right: there is no justification for it, compelling or othereise. In light of this, and the mountain of evidence that clearly demonstrates the many adverse consequences from this practice, it is inexplicable that just 6 months later, the Chairman – *at a conference organized by dealer-only trading platforms*– suggested that the Commission would not be "taking any action" to address the significant damage being caused by post-trade name disclosure.[40] Most recently, the Chairman indicated that the he was comfortable with the market as it currently exists, and as being "happy to leave it up to the market to decide which way it wants to trade."[41]

This remarkable refusal to act comes in the face of repeated calls from the most senior ranks of the Commission – including Commissioner Bowen,[42] former Commissioner Wetjen,[43] and the Director of the Division of Market Oversight, Vince McGonagle[44] – for prompt and decisive action to correct this pervasive anti-competitive practice in the market. In fact, the only discernible opponent of Commission action on this matter is Commissioner Giancarlo, a former executive of an interdealer broker that currently operates one of the dealer-only SEFs.

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[39] Remarks of Chairman Timothy Massad before the ISDA 30th Annual General Meeting (April 23, 2015), *available* at http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-17.

[40] *See*, *e.g.*, "CFTC not planning on anonymity for swaps market," Financial Times (October 26, 2015) *available* at http://www.ft.com/intl/fastft/414101/us-swaps-market and Robert Smith, "CFTC parks Sef name give-up issue," Risk.net (October 27, 2015) at http://www.risk.net/risk-magazine/news/2432073/cftc-parks-sef-name-give-up-issue.

[41] *See*, Catherine Contiguglia, "Massad: Let Markets Decide What it Wants From SEFs," Risk.net (January 25, 2016), *available* at http://www.risk.net/risk-magazine/news/2443177/massad-let-market-decide-what-it-wants-from-sefs.

[42] Statement of U.S. Commodity Futures Trading Commissioner Sharon Bowen Regarding Trading Practices on SEFs, (April 23, 2015) ("I was pleased to see the Chairman's statement regarding greater anonymity on SEFs in his speech today. I have not heard a compelling justification for post-trade name-give-up in my many discussions with market participants regarding SEFs. In fact, the subject of whether trading on SEFs should be anonymous was raised earlier this month at the first meeting of the Market Risk Advisory Committee, and I believe there is broad support for ending the practice of post-trade name-give-up on SEFs."), *available* at http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement042315.

[43] Remarks of Commissioner Mark Wetjen before the Cumberland Lodge Financial Services Policy Summit, (November 14, 2014) ("The CFTC also should take a careful look at the alleged information leakage resulting from post-trade affirmation services employed by SEFs. It's difficult to rationalize trading protocols that reveal the identities of counterparties on an anonymous, central limit order book."), *available* at http://www.cftc.gov/PressRoom/SpeechesTestimony/opawetjen-10.

[44] Peter Madigan, "CFTC to test role of anonymity in Sef order book flop," Risk.net (November 21, 2014) ("We are going to continue looking into this, we are going to ask questions of the Sefs and market participants, hopefully to the extent that this is an old business practice that was necessary for credit but that is no longer needed, and that it will quickly go away."), *available* at http://www.risk.net/risk-magazine/feature/2382497/cftc-to-test-role-of-anonymity-in-sef-order-book-flop.

Bolstering the overwhelming support within the Commission, a remarkably broad and diverse spectrum of market participants favor ending this practice as well. The Managed Funds Association has issued a white paper on *"Why Eliminating Post-Trade Name Disclosure Will Improve the Swaps Market"*[45] Further, at the CFTC's Market Risk Advisory Committee Meeting on April 2, 2015, nearly every participant favored eliminating post-trade name disclosure on SEFs, including traditional asset managers (Eaton Vance), alternative asset managements (D. E. Shaw, Citadel), dealers (UBS), SEFs (Bloomberg, ICAP), proprietary trading firms (FIA PTG), and public interest groups (Better Markets, Americans for Financial Reform).[46] In fact, the only meeting participant to defend the practice was from one of the four biggest incumbent dealer banks, Goldman Sachs.

A prominent academic professor studying the derivatives markets, Stanford University's Darrell Duffie,[47] has also highlighted the importance of eliminating post-trade name disclosure:

> "Anonymity is a critical component of exchange trading platforms because it allows entities to transact without disclosing their trading strategies to the wider market. The practice of name disclosure, accordingly, deters buy-side firms from trading on platforms with exchange-like features. The elimination of the practice of name disclosure would thus, in my view, significantly increase incentives for participation on new or existing CDS trading platforms with exchange-like features."[48]

As discussed in detail in the Managed Funds Association's white paper, there is no question that the CFTC has both the mandate and the authority to put an end to post-trade name disclosure on SEFs. In light of this overwhelimg evidence and support, it is a incomprehensible that the CFTC refuses to act.

Meanwhile, as part of the landmark $1.9 billion settlement of charges related to the big banks blocking competition in the credit derivatives markets, the dealer banks, via their trade association ISDA, agreed to:

> "formally consider and vote on a proposal for ISDA to make an official statement in favor of abolishing the practice of post-trade name disclosure."[49]

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[45] *See,* MFA Position Paper: Why Eliminating Post-Trade Name Disclosure Will Improve the Swaps Market (March 31, 2015), *available* at https://www.managedfunds.org/wp-content/uploads/2015/04/MFA-Position-Paper-on-Post-Trade-Name-Disclosure-Final.pdf.

[46] Webcast *available* at http://www.cftc.gov/PressRoom/Events/opaevent_mrac040215.

[47] Darrell Duffie is the Dean Witter Distinguished Professor of Finance at the Graduate School of Business, Stanford University, and Professor by Courtesy, Department of Economics, Stanford University.

[48] Declaration of Darrell Duffie In Support of Plaintiffs' Motion for Preliminary Approval of Settlement with all Defendants and Preliminary Certification of a Settlement Class, *In Re Credit Default Swaps Antitrust Litigation*, U.S. District Court SDNY (Oct. 16, 2015) at FN 3.

[49] Stipulation and Agreement of Settlement with International Swaps and Derivatives Association, *In Re Credit Default Swaps Antitrust Litigation*, U.S. District Court SDNY (Oct. 16, 2015) at Appendix A.

This draws a clear connection between the continuation of the practice and the prior anti-competitive behavior of these dealers, and the great interest of other market participants in abolishing the practice. However, in light of the Chairman's recent statement that the CFTC won't be taking action in the near-term, it appears this requirement in the settlement will be rendered meaningless and may well provide the cover ISDA needs just to vote not to make any statement at all.[50]

As a result, the Chairman's recent statements may well help to ensure that the market does not comply with the law and does not evolve into a truly competitive marketplace, even as a result of landmark antitrust settlements.

Solutions

We believe there are several common-sense steps U.S. regulators must take to get the intended derivatives trading reforms back on track for U.S. market participants and systemic stability.

1) Exercise oversight of activity conducted by swaps traders located in the U.S.

It is clear that derivatives activities engaged in by traders located in the U.S. have a direct and significant connection to the U.S. and warrant oversight from U.S. regulators. The CFTC specifically highlighted that it has a "strong supervisory interest in regulating the dealing activities that occur within the United States, irrespective of the counterparty."[51] This isn't a new concept. Indeed, exercising full jurisdication over activities within a country is as old as the concept of sovereignty itself. Thus, it is entirely consistent with other U.S. financial market reforms - such as the Volcker Rule[52] - that these rules apply to the activities of U.S. traders in the U.S. The CFTC should immediately enforce this baseline principle – regulating all derivatives activitites within the United States – and impose its existing rules, ceasing the continuous relief to the dealer banks to actually comply with them.

Even if so-called "substituted compliance" was appropriate for some of these activities (and they are not), U.S. regulators shouldn't completely abdicate their responsibility of oversight before ensuring that the foreign rules are in fact equivalent to U.S. standards in form, substance, enforcement and over time. For that reason, the SEC's recent proposal to exclude

[50] *See*, Peter Madigan, "Isda escape CDS case pledge to help CFTC," Risk.net (Nov. 9, 2015), *available* at http://www.risk.net/risk-magazine/news/2433887/isda-escapes-cds-case-pledge-to-help-cftc.

[51] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations; Rule, 78 Fed. Reg. 45292 (July 26, 2013) at FN 513.

[52] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (January 31, 2014) at 5655 ("Personnel that arrange, negotiate, or execute a purchase or sale conducted under the exemption for trading activity of a foreign banking entity mustbe located outside of the United States.").

traders at non-U.S. banks working in the U.S. from the trading reforms (which are the very reforms the dealers want to avoid the most) is inappropriate.[53]

2) Enforce CFTC rules on impartial access and eliminate post-trade name disclosure on SEFs

The CFTC has clear impartial access rules applicable to trading on SEFs. These must be actually enforced to ensure dealers are not able to preserve prohibited dealer-only platforms through other techniques, such as the practices highlighted above. In addition, the legacy practice of post-trade name disclosure cannot be justified for cleared derivatives. That only helps keep certain SEFs as dealer-only platforms in violation of the CFTC's impartial access requirements. Consistent with prior statements made by the CFTC Chairman, Commissioners and staff, post-trade name disclosure should be immediately prohibited for cleared derivatives on SEFs.

3) Promote harmonization with global regulators to eliminate regulatory arbitrage

By finalizing trading reforms first, U.S. regulators have seen the impact of regulatory arbitrage by U.S. dealers de-guaranteeing some of their affiliates and moving derivatives activity offshore. The next step in their efforts to evade U.S. laws and rules that protect U.S. taxpayers is to get the CFTC to allow as much so-called substituted compliance (i.e., authorize following foreign law rather than US law) as possible. In conjuction with evading US laws and rules, their efforts include working to make sure that foreign law is as minimal as possible, i.e., not genuinely or substantively equivalent in fact.

It is therefore critical that U.S. regulators continue to promote harmonization with global regulators and ensure substituted compliance isn't granted unless U.S. core principles such as impartial access are implemented in an equivalent manner in fact, so that U.S. market participants can't be shut-out of swaps trading venues. In the face of dealer opposition and evasion, the CFTC must not back away from its current approach for granting trading venue equivalence, which requires as a pre-condition that impartial access be implemented in an equivalent manner.[54]

4) Ensure transparency regarding the derivatives activities of de-guaranteed affiliates

To adequately assess the risks these newly de-guaranteed affiliates of U.S. entities may pose to the U.S. financial system, at a minimum there needs to be full transparency around their derivatives activities and a 'de facto guarantee' test must be applied to ensure that U.S. law

[53] 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. 27,444 (May 13, 2015).

[54] *See,* CFTC Letter 14-46 (April 9, 2014), *available* at http://www.cftc.gov/idc/groups/public/@lrlettergeneral/documents/letter/14-46.pdf

is not being evaded.[55] U.S. regulators have the obligation to understand how U.S. financial reforms may be undermined by the act of de-guaranteeing and use their anti-evasion authority whenever appropriate.

[55] *See*, Better Markets Fact Sheet on De-Guaranteeing, *available at* http://bettermarkets.com/sites/default/files/Cross-Border%20Guarantee%20Fact%20Sheet%206-19-14%20%282%29.pdf.