March 10, 2014

Acting Chairman Mark Wetjen
Commissioner Bart Chilton
Commissioner Scott O'Malia
c/o Ms. Melissa D. Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW.
Washington, DC 20581

Re: Request for Comment on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non-U.S. Swap Dealers Located in the United States ("Release")

Dear Acting Chairman and Commissioners:

Better Markets Inc.[1] appreciates the opportunity to comment on the above-captioned Release, issued by the Commodity Futures Trading Commission ("CFTC" or "Commission") in connection with Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

INTRODUCTION

Strong, Effective Cross-Border Regulation is Required by Law and Essential to Protect the U.S. and U.S. Taxpayers

The derivatives markets have evolved and expanded to the point where transactions routinely take place in multiple jurisdictions and even multiple continents. Moreover, trades booked abroad can transmit significant risks back home to U.S. financial institutions, the U.S. financial system, the U.S. economy as a whole, and ultimately to U.S. taxpayers. This was clearly and painfully illustrated during the financial crisis of 2008, when over-the-counter derivatives incubated and triggered a global financial meltdown.

The frequently-cited examples from the 2008 crisis include Bear Stearns (Cayman affiliates operating in New York with swaps desks in London), Lehman Brothers (swaps book run out of London), AIG Financial Products (French affiliate operating in London), and Citigroup (Cayman affiliates operating in London). Two examples that demonstrate that

[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.

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cross-border risks return to the United States, even if they don't cost taxpayers directly, are the JP Morgan Chase "London Whale" loss (London branch) and the Long Term Capital Management collapse (Cayman affiliates operated in London).

But, that's not all. The U.S. had to bail out the global financial system in general and foreign banks and dealers in particular. For example, of the 22 AIG counterparties bailed out by the U.S. government, 17 were foreign banks. Of the 20 largest users of Federal Reserve Bank's emergency lending facilities, nine were foreign banks. Also, the Fed pumped $1.9 trillion into foreign swap lines in the 30 days after the collapse of Lehman Brothers and $5.4 trillion in the 90 days after its collapse.

The ongoing costs of those historic events to the people, communities, and government of the United States will be more than $12.8 trillion over ten years (not including the costs of the Fed's zero interest rate policy and asset purchases, all of which have been necessitated by the massive damage done by the financial collapse).[2] Of course, the dollar cost, almost unimaginably large, will still never capture the human suffering and economic wreckage inflicted on our country from coast to coast by the financial and economic crises.

Protecting the American people from the devastation of another financial crisis and another long list of costly bailouts is what is at stake in cross-border regulation. Congress and the Executive expressly recognized that threat by passing a law that specifically requires the CFTC to apply the new derivatives regulations under the Dodd-Frank Act to any offshore transactions that "have a direct and significant connection with activities in, or effect on, commerce of the United States."[3]

After years of consideration, input from the industry, and multiple delays at the request of foreign regulators, the CFTC issued final interpretive guidance on July 5, 2013 on the cross-border application of Title VII derivatives regulations ("Final Guidance") under the statutory mandate set forth above ("Section 2(i)"). In response to yet more requests from industry participants, the Division of Swap Dealer and Intermediary Oversight ("DSIO") issued a Staff Advisory ("Advisory") on November 14, 2013 to clarify the treatment of certain transactions conducted between non-U.S. counterparties. On January 3, 2014, the Commission issued the Release, seeking comment on certain procedural and substantive aspects of the Advisory.

Very importantly, the request for comment arose because certain members of the industry are asking to engage in what are referred to as "front office" derivatives activities, some of which could and will be very substantial, within the United States, but to be entirely free from U.S. regulations or laws. This would be a dramatic departure from precedent, practice, policy, and common sense. The industry participants seeking such a

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2 *See* BETTER MARKETS, THE COST OF THE WALL STREET COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis.pdf.

3 Commodity Exchange Act, Section 2(i).

dramatic departure claim it is appropriate solely because the parties to the derivatives transactions just happen to be non-U.S. persons. That, however, does not change the fact that the non-U.S. swap dealer, registered as a dealer with the Commission, is engaged in front office derivatives activities, some very substantial, **within the United States.**

Allowing this would create a gaping loophole whereby registered swap dealers would ensure that all such transactions be booked overseas, but otherwise handled in the U.S. This would result in the keystroke off-shoring of the bookings, but otherwise the on-shoring of the core activities associated with the transaction, which would not be subject to U.S. laws or regulation. Allowing such "keystroke evasion" of regulations and laws would be an open invitation to massive regulatory arbitrage that should not be permitted.

Moreover, this would not only be form over substance, but would almost assuredly unleash a widespread restructuring of derivative deal "forms" so that the substance of those transactions would not be regulated. That is what happened with the "swap-ization" of futures after passage of the CFMA and the "re-futurization" of swaps after the passage of the Dodd-Frank rules (not to mention the structuring of CDS to evade insurance regulations). It made no sense then and makes no sense now to allow fiction to dictate regulation.

SUMMARY OF COMMENTS

The Advisory clearly represents a clarification and elucidation of a policy already determined by the Commission and communicated in the Final Guidance. Moreover, the Advisory is entirely consistent with the Final Guidance. Therefore, adopting the Advisory as Commission policy is unnecessary. In addition, undertaking that step would entail a wasteful expenditure of Commission resources and an unnecessary delay in finalizing the framework for the application of Title VII to cross-border transactions, as required by the law passed in July 2010.

Further, allowing substituted compliance for the transactions described in the Advisory would be inconsistent with the Commission's treatment of other transactions in which it also has a strong supervisory interest. However, if the Commission decides that a dramatic departure from precedent, practice, policy, and common sense is somehow appropriate here and considers making substituted compliance available for activities of dealers in the U.S., then it must only be made available for jurisdictions and for requirements where the substituted regimes are substantively identical to those of the U.S. in form, substance, enforcement, and over time.

The Advisory Provides Requested Clarification of Existing Commission Policy

The Advisory follows naturally from, and is consistent with, the Final Guidance. Indeed, it represents the only reasonable interpretation of Congress's mandate to regulate swaps transactions with a "direct and significant connection with activities in, or effect on, commerce of the United States."

The Advisory clarifies the treatment of swap transactions conducted between non-U.S. counterparties that are conducted through the front office of a non-U.S. Swap Dealer ("SD") **located in the U.S.** In practical language, this refers to situations where trades conducted between, for example, the New York sales and trading desk of a non-U.S. Swap Dealer and a foreign client are booked abroad. According to the Advisory:

> "DSIO believes that persons regularly arranging, negotiating, or executing swaps for or on behalf of an SD are performing core, front-office activities of that SD's dealing business. Thus, DSIO is of the view that a non-U.S. SD (whether an affiliate or not of a U.S. person) regularly using personnel or agents **located in the U.S.** to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with the Transaction-Level Requirements. For the avoidance of doubt, the Division's view would also apply to a swap between a non-U.S. SD and a non-U.S. person booked in a non-U.S. branch of the non-U.S. SD if the non-U.S. SD is using personnel or agents **located in the U.S.** to arrange, negotiate, or execute such swap."[4]

The Final Guidance, which the Advisory seeks to clarify, often describes the applicability of compliance requirements according to the specific qualities of the counterparties to the transaction (U.S. Persons, non-U.S. Persons, branches, affiliates, etc.). It does not, however, exclusively follow a counterparty-based determination approach. Rather, the Final Guidance, consistent with the statute, applies certain Dodd-Frank requirements to counterparties based on the connection of their "activities" with the United States. The situation to which the Advisory speaks is indeed an example of one where U.S. activities are specifically the differentiating factor. The swaps of interest in this particular context are not categorized by the nature or location of the counterparties at all, but rather the location in which the substantive business was conducted, irrespective of the ultimate booking location.

As the Commission states in the Final Guidance:

> "[T]he Commission also recognizes its **strong supervisory interest in regulating the dealing activities that occur with the United States, irrespective of the counterparty** (just as the Commission allows for substituted compliance for foreign branches in certain instances to take into account the strong supervisory interest of local regulators)."[5]

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4 *See* CFTC Division of Swap Dealer and Intermediary Oversight Advisory (Nov. 13, 2013), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-69.pdf (emphasis added).

5 Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, footnote 513 (emphasis added).

There is no dispute that transactions arranged, executed, or negotiated in the U.S. have indeed occurred in the U.S. Importantly, the terms "arrange, execute, or negotiate" are the precise definitions of the functions performed by brokers, structurers, traders, and salesmen, who collectively comprise the general understanding of the core front office. Put another way, regardless of where a trade is ultimately booked, the business is conducted wherever these front office personnel sit. Thus, if any of these core activities were performed in the U.S., then swap dealing activities occurred in the U.S.

It is notable that the industry request to clarify the Final Guidance with respect to the transactions in question resulted from **a split between the interpretations of industry participants**. Thus, there is no doubt that at least some, if not all, industry participants understood the intended treatment of such swaps, and the Advisory only served to confirm that understanding.[6] Put another way, it appears that all industry participants who did not have a specific economic interest in contesting the plain language and logic of the statute and Final Guidance had no need for any clarification. It was only market participants that sought to engage in impermissible activity **within the U.S.** that created the need for clarification (and those market participants are now just seeking to re-litigate the issue yet again).

The Advisory served to specify some additional examples of transactions to which transaction-level requirements, according to the Commission's Final Guidance, would apply. In particular, it provided examples where transaction-level compliance requirements would apply to transactions that would not otherwise trigger such requirements according to their counterparty qualities. This is yet more evidence that the Staff Advisory, in total, served to elucidate existing Commission policy.

It did not constitute any change, expansion, or other modification of the Commission's approach to regulating business conducted in the U.S. as indicated in the Final Guidance and as required by the statute.

Indeed, any other interpretation of the language in the Final Guidance would amount to an enormous change of the Final Guidance and de facto loophole through which much of the business conducted by swap dealers would be exempt from critical compliance requirements mandated by the Dodd-Frank Act as set forth in the Final Guidance.[7] The alternative scenario argued for by some industry participants, where such trades were not subject to transaction-level requirements, would effectively exempt all trading between

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[6] "Banks Said to Seize 'Footnote 513' to Keep Swaps Private", Bloomberg, October 23, 2013, *available at* http://www.bloomberg.com/news/2013-10-23/banks-said-to-seize-footnote-513-to-keep-swaps-private.html.

[7] "The biggest banks sometimes trade half their swaps with overseas clients." *See* "Banks Said to Seize 'Footnote 513' to Keep Swaps Private", Bloomberg, October 23, 2013, *available at* http://www.bloomberg.com/news/2013-10-23/banks-said-to-seize-footnote-513-to-keep-swaps-private.html.

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non-U.S. Persons from the core Dodd-Frank Act compliance requirements mandated by Congress, **regardless of a direct and significant connection with the U.S.**

In this scenario, swap dealers could – and surely would – simply book all trades with non-U.S. counterparties out of a foreign affiliate and avoid complying with key provisions of the statute, thereby evading and gutting the key components of financial reform. Thus, financial reform and the protection of U.S. taxpayers, the financial system, and the economy would be evaded and defeated by a few keystrokes, allowing the artificially chosen geographic location to trump economic and business substance.

Given the scope of the Commission's Final Guidance on cross-border transactions, it is inconceivable that it would intend to exempt a significant proportion of dealing activity **conducted in the U.S.** from substantive compliance requirements and thereby incentivize and reward regulatory arbitrage. Indeed, such an indefensible interpretation would be the starting gun for a global race to the regulatory bottom, risking the U.S. and global progress on derivatives market reforms.

For this reason, the adoption of the Staff Advisory as Commission policy, suggested as a possibility in the Release, would be redundant and unnecessary. The Advisory does not contain any departure from the policies indicated in the Final Guidance, and is a paradigmatic example of information appropriately issued by CFTC Staff in response to industry requests for clarification. Subjecting incidental staff communications to the lengthy process of Commission consideration and vote would amount to an unwarranted misuse of Commission resources while causing continued uncertainty and delay to market participants.

Moreover, it could set a precedent that would empower any market participants that did not agree with a particular Commission action to claim confusion or need for clarification, thereby causing potentially unending delay and confusion in the marketplace. It risks nothing being final as settled matters become un-settled and re-visited again and again. Staff advisories are a critical means by which the Commission can quickly and appropriately respond to such matters, as was done here.

If the Commission Elevates Form Over Substance and Departs from Precedent, Practice, Policy, and Common Sense by Allowing Substituted Compliance in the U.S. for Dealer Activities in the U.S., It Must Only Do So Where Foreign Regulatory Regimes Are Sufficiently Robust and Comparable

In the Final Guidance, the Commission stated specifically that it has a strong supervisory interest in all swap dealing activity that takes place in the U.S.[8] Further, the Commission recognized the comparable interest of foreign regulators in certain

[8] The other strong supervisory interests, as indicated in the Final Guidance, include: entities that are part or an extension of a U.S.-based swap dealer, non-U.S. swap dealers and non-U.S. Major Swap Participants registered under the Commodity Exchange Act, and transactions where one counterparty is a U.S. Person.

transactions conducted within their own jurisdictions. This is precisely the justification for making substituted compliance overseas available for such transactions.

The statute, of course, does not specifically provide for substituted compliance, but the Commission has nonetheless decided that principles of international comity and regulatory cooperation warrant such allowances where an in-fact equivalent foreign regulatory and enforcement regime exists.

If the Commission does contemplate making substituted compliance available to transactions between foreign counterparties which are conducted in the U.S., it is critically important that the applicable foreign regimes are sufficiently comprehensive to satisfy the strong supervisory interest of the CFTC as required by the statute. The strong supervisory interest in these transactions in the U.S., as compared to other categories of trades for which substituted compliance may be available overseas, must require a more robust determination process for comparability of foreign regimes. Such a regime must be **in fact** equivalent not only in form but also in substance, enforcement, and over time.

Specifically, insofar as substituted compliance is permitted, it must adhere to the following important criteria:

- Foreign regulations must be evaluated on a case-by-case basis, and never given a blanket exemption for substituted compliance.
- Any foreign regulation that is determined appropriate for substituted compliance must be equivalent to the relevant U.S. regulation(s) in form, in substance, and over time.
- The foreign regulatory regime must incorporate strong investigative tools and meaningful penalty provisions, and the foreign regulator must have a demonstrable record of enforcement and the resources to carry out the mandate.
- Any entity making use of substituted compliance must be held responsible for promptly informing the CFTC if either the relevant regulation or the factors that qualified the entity for substituted compliance change in any material way.
- The exemption based on substituted compliance must be periodically reviewed and renewed.

With respect to the individual requirements, any contemplation of allowing substituted compliance for transactions between non-U.S. counterparties occurring in the U.S. must only proceed in cases where specific conditions have been met by the comparable regime. We will discuss the critical features of each transaction-level requirement below.

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Critical Properties of Transaction-Level Requirements for Substitutability

Required Clearing and Swap Processing: Additive coverage of clearing mandates, in the style of the joint agreement between the CFTC and European regulators, is the only appropriate approach. That is, all swaps required to be cleared in the United States must also be required to be cleared when covered entities book them overseas. Similarly, swaps that might not be required to be cleared in the United States must be cleared when booked overseas if those swaps are part of the clearing mandate of the foreign jurisdiction in question.[9]

Margining and Segregation for Uncleared Swaps: In stressed situations, it is the initial margin, **not** the variation margin that prevents a crisis from occurring, since the variation margin will only cover the fluctuations that have already occurred, **not** the sudden fluctuations that occur in a short period of time during a stressed market. Thus, deployment of capital in the form of initial margin is not redundant – it is essential to managing the contagion risk of localized fluctuations. The CFTC must only allow substituted compliance in jurisdictions where initial margin – in addition to variation margin – is **fully** assessed. To the extent that a foreign regime does not asses such margin, it should not be available to the trades in question.

Trade Execution: Execution on foreign platforms must only be permitted to the extent that the platform follows rules substantially identical to swap execution facilities. The specifications required by the CFTC in providing No Action relief to certain multilateral trading facilities[10] are an appropriate model for substantive equivalence. Namely, acceptable foreign execution must only be permitted on platforms that use a central limit order book, and conform to U.S. block rules, Request For Quote thresholds, and non-discriminatory open access protocols.

Swap Trading Relationship Documentation: Proper swap trading relationship documentation is essential to fair and impartial valuation of swaps contracts. Absent such documentation, resolution of swaps and exchange of collateral can require lengthy and cumbersome arbitration. Particularly in a stressed market situation, this can be highly risky and inefficient. The CFTC must ensure that substituted compliance for this requirement is only considered with respect to swap trading relationship documentation if the foreign regime has rules that facilitate timely, impartial valuation of all relevant swaps contracts.

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9 Joint Statement by CFTC Chairman Gary Gensler and European Commissioner Michel Barnier on the Financial Reform Agenda (Sept. 28, 2010), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr5905-10.

10 CFTC No-Action Letter "Time-Limited No-Action Relief with respect to Swaps Trading on Certain Multilateral Trading Facilities Overseen by Competent Authorities Designated by European Union Member States" (Feb. 12, 2014), *available at* http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-15.pdf.

Portfolio Reconciliation and Compression: It is essential that the Commission only allow substituted compliance in cases where the foreign regime requires portfolio reconciliation and compression on a regular basis, and the rules governing the processes require variation margin to be assessed in a timely and accurate fashion, and valuation discrepancies to be resolved as quickly as possible.

Real-Time Public Reporting: The CFTC must not permit substituted compliance for reporting in any case where the foreign regime lacks a real-time reporting requirement substantially identical to that of the United States. Otherwise, the transparency of swaps markets will be completely undermined. This would be a direct and significant detriment to U.S. commerce and it would violate the Commission's statutory duty.

Trade Confirmation: Any substituted compliance determination with respect to trade confirmations must specifically look for equivalence in the trade confirmation requirement, including in particular the exchange of pre-trade term sheets.

Daily Trading Records: Any substituted compliance made available for those trades in question must only include regimes that requires the preservation of all necessary information to comprehensively reconstruct each trade, and that require that the information be made available promptly to regulators in an identifiable and searchable form.

To the extent that foreign regimes do not meet these specifications for any particular requirement, the transactions in question must not be allowed to substitute their compliance with the requirement. That is to say, substituted compliance simply cannot be allowed to become a mechanism for evading the most basic and necessary rules and requirements enacted to protect U.S. taxpayers, the financial system, and the economy. Substituted compliance, if it is to be used at all, must only be allowed where the foreign jurisdiction is equivalent in form, substance, enforcement, and over time as determined on a case by case basis. To do otherwise would violate the law and pose unacceptable threats to the American people.

Foreign Regulatory Regimes Remain Largely Incomparable

It is abundantly clear that no foreign regimes are currently equivalent to that of the U.S. in form, substance, and over time. Although all the member states of the G-20 committed to central clearing of most derivatives by the end of 2012, only the United States and Japan have accomplished this so far.[11] This is merely symptomatic of a broader mismatch between the successful implementation of necessary financial reforms in the United States following the financial crisis and the much slower, weaker, or nonexistent reforms overseas.

[11] Financial Stability Board, "OTC Derivatives Market Reforms" (June 15, 2012), p. 3, *available at* http://www.financialstabilityboard.org/publications/r_120615.pdf.

Even those regimes that have made the most progress in their financial reform efforts, Europe and Japan, are nowhere near achieving comparability to U.S. regulations. For example, while the EU has made progress, particularly recently, even MiFID II may not be in place until 2015. Even then, it will require implementation by individual European member states, pushing full implementation out to at least 2019.

And, although Japan has implemented some important derivatives reforms such as mandatory central clearing for some swaps, its scope is far narrower than that of Title VII of Dodd-Frank. Additionally, its regime lacks real-time reporting, confirmation, and margin requirements for uncleared swaps – all central aspects of the Title VII approach. Such a regime simply would **not** contain the essential elements that Congress deemed necessary to curtail systemic risk and protect the American taxpayer, despite the fact that swaps activity subject to these weaker requirements would "have a direct and significant connection with activities in, or effect on, commerce of the United States" – the criteria Congress set out for cross-border application of Title VII.

Importantly, the problems run deeper than just the pace of foreign derivatives regulation. As the Standard Chartered and HSBC money laundering cases,[12] along with the Libor, FX, and ISDAfix scandals,[13] demonstrate, foreign regulators too often appear to continue to have a "light touch" regulatory approach and a lack of commitment to enforcement.[14] In addition, the incentives for overseas regulators and legislators are simply not the same as those in the United States. With the United States government and U.S. taxpayers as the ultimate backstop to the global financial system, foreign jurisdictions simply lack the same incentive for a strong, robust regulatory regime that truly prevents another financial crisis and more bailouts.

Thus, unless overseas jurisdictions are able to meet the standards of the United States – required by law to protect the U.S. financial system and U.S. taxpayers – then substituted compliance cannot be an option for those dealer activities in the U.S. in which the CFTC has a strong supervisory interest, as required by law. They simply cannot protect the U.S. financial system, taxpayer, or economy as Congress has directed the CFTC to do.

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12 "HSBC to Pay $1.92 Billion to Settle Charges of Money Laundering," New York Times, December 10, 2012, *available at* http://dealbook.nytimes.com/2012/12/10/hsbc-said-to-near-1-9-billion-settlement-over-money-laundering/.

13 "Timeline: Libor-fixing scandal," BBC, February 6, 2013, *available at* http://www.bbc.co.uk/news/business-18671255.

14 "Reputation is crucial for bank investors," Financial Times, December 21, 2012, *available at* http://www.ft.com/intl/cms/s/0/26c1b3c6-4b5f-11e2-88b5-00144feab49a.html#axzz2JQxD48bv.

CONCLUSION

We hope that this comment letter aids the CFTC in its effort to deal with this important issue.

Sincerely,

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