June 10, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Rules Relating to Security-Based Swap Execution and Registration and Regulation of Security-Based Swap Execution Facilities (File No. S7-14-22, RIN 3235-AK93)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned proposal ("Proposal" or "Release") issued by the Securities and Exchange Commission ("SEC" or "Commission").[2] The Proposal would finally establish the rules applicable to the execution of security-based swaps ("SBS") and the regulation of security-based swap execution facilities ("SBSEF"). In the Proposal, the Commission takes the approach of attempting to achieve as much consistency as possible with the rules established by the Commodity Futures Trading Commission ("CFTC") related to execution of swaps and regulation of swap execution facilities ("SEF").

Among other things, the Proposal would institute a registration regime for SBSEFs, establish a trade execution requirement, establish the process by which SBSEFs could trade new products, and addresses the cross-border application of rules on SBSEFs. The Proposal is strong in many respects, but we urge the SEC to close the de facto exemption from registration for single-dealer platforms, abandon the self-certification approach to the review and approval of new product offerings, and fortify the cross-border regime by capturing the activities of foreign entities that are de facto guaranteed by U.S. persons.

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

2 87 Fed. Reg. 14,950 (Mar. 16, 2022).

INTRODUCTION AND BACKGROUND

The Prominent Role of SBS in the Financial Crisis

Although the SBS market is a "small fraction of the overall swap market,"[3] SBS, and in particular single-name credit default swaps ("CDS"), figured prominently in the financial crisis. CDS are insurance-like contracts in which a "protection seller" agrees to make a payout to a "protection buyer" if a particular company, or other reference entity, experiences a "credit event," such as a default on its debt. In turn, the protection buyer pays premiums to the protection seller.[4] Unlike insurance, however, the protection buyer is not necessarily protecting itself against any risk of loss of an asset it owns. For example, you can purchase fire insurance to protect yourself against the risk that a home you own will be destroyed by fire. However, under the insurable interest requirement, you cannot, as a general rule, purchase fire insurance on your neighbor's house.[5] However, while a protection buyer in a CDS *could* be someone who actually owns the debt of a particular company and seeks to hedge that exposure, it could also simply be someone who thinks the company will default on its debt and wants to make money from that expectation, *i.e.* a speculator. This distinction between the traditional insurance market and instruments such as CDS has key implications for the regulation of fraud and manipulation in the SBS market.

When CDS burst onto the scene in the early 1990s, many stakeholders in the financial industry, including regulators, thought they would have an enormous and positive impact on the financial system. Essentially, the thinking went, CDS allows lenders, primarily heavily regulated (and highly leveraged) banks, to better fulfill their lending-oriented purpose. If banks can easily offload much or all of the risk of making loans onto entities with a greater ability and willingness to absorb that risk, then banks can make more loans to people who can put that money to productive use. Moreover, the subsequent dispersal of that risk would purportedly make the financial system safer.[6] This confidence in the beneficial impact of CDS and other types of swaps led to a concerted and successful push to exempt them from meaningful regulation, on the argument that government regulation of these supposedly innovative products could only be harmful. This ultimately misguided view was accompanied and justified by the belief that market self-discipline and self-

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3 Release at 28,875.

4 Adam Reiser, *Should Insider Trading in Credit Default Swap Markets Be Regulated? The Landmark Significance of Sec v. Rorech*, 9 DEPAUL BUS. & COM. L.J. 531, 534 (2011).

5 Thomas Lee Hazen, *Filling A Regulatory Gap: It Is Time to Regulate over-the-Counter Derivatives*, 13 N.C. BANKING INST. 123, 131–32 (2009) ("An insurable interest has long been a requirement of insurance law. It requires an insurable interest in the contingency insured against in order to uphold the insurance contract."). The policy considerations underlying the insurable interest doctrine include the need to differentiate insurance contracts from wagering contracts and to reduce the moral hazard arising from the incentive to destroy the insured property or other interest to benefit from the insurance contract.

6 Adam Reiser, *Should Insider Trading in Credit Default Swap Markets Be Regulated? The Landmark Significance of Sec v. Rorech*, 9 DEPAUL BUS. & COM. L.J. 531, 534 (2011).

interest would be all the regulation needed to prevent serious systemic risks or patterns of abuse from arising.[7]

Ultimately, the CDS promoters were half right. CDS did have an enormous impact on the financial system. But that impact was not in improving the financial system but in nearly destroying it, making the need for strong regulation of the CDS market, and in particular the need for increased transparency and the prevention of fraud and manipulation in the CDS market, abundantly and tragically apparent.

It did not take long for events to reveal that the assumptions underlying the decision not to regulate CDS and other swaps were hopelessly naïve. To the extent that CDS (and other related innovations such as mortgage-backed securities and adjustable-rate mortgages) facilitated increased lending, it did so through moral hazard that incentivized reckless and often illegal conduct. Lenders (especially non-bank lenders) that no longer were going to hold mortgage loans on their books felt that they no longer needed to engage in robust underwriting of those loans.[8] Indeed, not only did this moral hazard lead to the deterioration of underwriting practices, it also incentivized lenders to engage in outright fraud. The widespread proliferation of so-called "NINJA" loans, which were extended to borrowers with "no income, no job, and no assets" in the runup to the crisis, illustrates both the negligence and fraud that the CDS-facilitated increase in lending helped create.[9] Similarly, while CDS promoters thought that CDS would facilitate greater dispersal of risk, instead CDS facilitated greater interconnectedness. This interconnectedness increased systemic risk by linking the fortunes of systemically significant institutions with each other, such that instability at one inevitably led to instability at others. This is how a downturn in the housing market nearly brought down the financial system.[10]

CDS did not just facilitate fraud and manipulation in the mortgage markets. One direct impact of the lack of regulation and transparency in the CDS market was to enable an increase in of fraud and manipulation beyond the mortgage market.[11] The CDS market itself became a

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[7] Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES (Oct. 8, 2008), https://www.nytimes.com/2008/10/09/business/economy/09greenspan.html; *see also* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 (2000).

[8] *See* René M. Stulz, *Credit Default Swaps and the Credit Crisis*, 24 J. ECON. PERSP. 73, 78 (2010) (explaining that CDS may have contributed to buildup of excessive risk in subprime mortgage market by "contribut[ing] to a false sense of safety of investors through hedges that were more imperfect than they thought and led to prices that underestimated risk."), https://www.jstor.org/stable/pdf/25703483.pdf?refreqid=fastly-default%3Acc0db83884aa199fd0c4eab3bc1509b5&ab_segments=&origin=.

[9] Mark Ireland, *After the Storm: Asymmetrical Information, Game Theory, and an Examination of the "Minnesota Model" for National Regulation of Mortgage Brokers and Tomorrow's Predatory Lenders*, 36 WM. MITCHELL L. REV. 1, 14 (2009).

[10] Steven L. Schwarcz, *Regulating Derivatives: A Fundamental Rethinking*, 70 DUKE L.J. 545, 564–65 (2020) (explaining how CDS create "an interconnectedness that drives systemic risk" because the "failure of a systemically important counterparty can lead to a domino effect, triggering a chain of failures.")

[11] Marlene Haas & Julia Reynolds, *CDS Market Transparency and Equity Market Quality* (Aug. 3, 2020) ("Another concern was the potential for manipulation and fraud in the CDS market, driven by a lack of regulatory oversight and transparency."), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2606164.

breeding ground for significant fraud in CDS transactions, notwithstanding the assertion that the sophisticated players in the derivatives markets could and would protect and regulate themselves. Perhaps the most infamous example of fraud in the CDS market in the runup to the crisis involved Goldman Sachs and a set of synthetic collateralized debt obligations ("CDOs") collectively known as "ABACUS." Goldman Sachs structured and marketed the ABACUS CDOs, telling investors that the residential mortgage-backed securities in them had been independently selected by a collateral manager.[12] In fact, Goldman had created the ABACUS CDO at the request of another client, hedge fund manager John Paulson, who wanted to **short** the housing market. Paulson wanted Goldman to create the ABACUS CDOs so that he could then purchase a CDS from Goldman ostensibly protecting against their failure. In fact, he wanted Goldman to create the ABACUS CDOs so he could bet on them to fail.[13] Moreover, Paulson was heavily involved in the portfolio selection process for the ABACUS CDOs, and so was able to populate them with securities he thought would fail, thus ensuring the profitability of his short position (the collateral agent that was ultimately responsible for selecting the securities was under the impression that Paulson was long the CDO).[14]

Naturally, Goldman did not tell the clients to whom it marketed the ABACUS CDOs that it had created them at the behest of another client who wanted them to fail, nor did it disclose that it had allowed that client to be involved in selecting the securities that would go into the CDO to ensure its failure.[15] The CDO transaction closed in April 2007, poor timing (in hindsight) to invest in the housing market—except for those forecasting a downturn and shorting the market. Unsurprisingly, the portfolio, much of which had been hand-selected by Paulson specifically to lose value, lost value—in less than a year **99%** of the portfolio had been downgraded.[16] Goldman settled with the SEC for a then-record $550 million and has been subject to ongoing suits as a result of its fraud.[17]

The lack of regulation surrounding CDS not only facilitated abuses but also deprived regulators and market participants of essential information about that marketplace. That lack of transparency also contributed to the financial crisis by concealing the buildup of risk from policymakers, as the Financial Crisis Inquiry Commission's Report ("FCIC Report") explains:

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12 Compl. at 1-2, *SEC v. Goldman Sachs & Co.*, No. 10-cv-3229 (S.D.N.Y 2010).

13 Compl. at 2, *SEC v. Goldman Sachs & Co.*, No. 10-cv-3229 (S.D.N.Y 2010).

14 Compl. at 2, *SEC v. Goldman Sachs & Co.*, No. 10-cv-3229 (S.D.N.Y 2010).

15 Compl. at 2, *SEC v. Goldman Sachs & Co.*, No. 10-cv-3229 (S.D.N.Y 2010).

16 Jennifer O'Hare, *Synthetic CDOs, Conflicts of Interest, and Securities Fraud*, 48 U. RICH. L. REV. 667, 685 (2014).

17 *See* SEC Press Release, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime CDO (Jul. 15, 2010), https://www.sec.gov/litigation/litreleases/2010/lr21592.htm; *Goldman Sachs Grp., Inc. v. Arkansas Tchr. Ret. Sys.*, 141 S. Ct. 1951 (2021); *see also* Brief of Better Markets, Inc. as Amicus Curiae in Support of Respondents, *Goldman Sachs Grp., Inc. v. Arkansas Tchr. Ret. Sys.*, 141 S. Ct. 1951 (2021), https://www.supremecourt.gov/DocketPDF/20/20-222/170888/20210304100303497_20-222%20Amicus%20Brief%20of%20Better%20Markets%20Inc.pdf.

"The scale and nature of the over-the-counter (OTC) derivatives market created significant systemic risk throughout the financial system and helped fuel the panic in the fall of 2008: millions of contracts in this opaque and deregulated market created interconnections among a vast web of financial institutions through counterparty credit risk, thus exposing the system to a contagion of spreading losses and defaults. Enormous positions concentrated in the hands of systemically significant institutions that were major OTC derivatives dealers added to uncertainty in the market. The "bank runs" on these institutions included runs on their derivatives operations through novations, collateral demands, and refusals to act as counterparties."[18]

And as the FCIC Report further explained, that lack of transparency also exacerbated the crisis in key moments as it was unfolding:

"AIG's failure was possible because of the sweeping deregulation of over-the-counter (OTC) derivatives, including credit default swaps, which effectively eliminated federal and state regulation of these products, including capital and margin requirements that would have lessened the likelihood of AIG's failure. The OTC derivatives market's lack of transparency and of effective price discovery exacerbated the collateral disputes of AIG and Goldman Sachs and similar disputes between other derivatives counterparties."[19]

Ultimately, unregulated SBS, especially CDS, and the lack of transparency, excessive risk-taking, fraud, and manipulation they enabled, contributed directly to the devastating 2008 financial crisis. That crisis resulted in an astonishing $20 trillion in losses to the American economy.[20] Yet that unbelievable number underestimates the true impact of the crisis, because the human cost will always be incalculable, as millions were forced, through no fault of their own, to suffer the fallout from lost jobs, lost houses, lost families, and even lost lives.[21]

Congress reacted to the destructive role of swaps and SBS in the financial crisis by passing Title VII of the Dodd-Frank Act to comprehensively transform the swaps and SBS market. Importantly, the Title VII reforms were modeled, in part, after the futures market, which performed well during the crisis. This included swap and SBS dealer registration requirements; the introduction of new regulated exchanges to trade swaps and SBS, *i.e.* the swap execution facility ("SEF") for swaps and the security-based swaps execution facility ("SBSEF") for SBS, as regulated, open, and transparent multilateral swaps trading venues intended to fundamentally transform the OTC derivatives markets; broad mandatory clearing and trade execution

18 Financial Crisis Inquiry Commission ("FCIC") Report XX (2011).

19 FCIC Report at 386.

20 BETTER MARKETS, THE COST OF THE CRISIS: $20 TRILLION AND COUNTING (2015), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

21 Shu-Sen Chang, et al., *Impact of 2008 Global Economic Crisis on Suicide: Time Trend Study in 54 Countries*, THE BMJ (Aug. 12, 2013), https://www.bmj.com/content/347/bmj.f5239.

requirements for swaps and SBS; public reporting of swaps and SBS transactions; and business conduct standards.

Congress directed the CFTC and SEC to write rules implementing the new SBS requirements, including requirements relating to SEFs and SBSEFs.[22] In June 2013, the CFTC finalized rules relating to SEFs, which have been in place, largely as adopted in 2013, since.[23] In 2011, the SEC proposed rules relating to SBSEFs, but those rules have not been finalized, and to the extent they are related to the current Proposal, are being withdrawn.[24]

Ongoing issues in the SBS and CDS Market in the Absence of a Complete Regulatory Framework

The aftermath of the financial crisis brought some reform to the SBS market, in the form of Title VII of the Dodd-Frank Act, which subjected both swaps and SBS to comprehensive regulation and directed the SEC to implement the new framework through its rules. While this has led to some increases in transparency and accountability in the SBS market, in the absence of a comprehensive framework for the trading of SBS, including a framework establishing the requirements for SBSEFs, there remain ongoing issues in the SBS market.

Manufactured Credit Events

Prominent among those persistent threats are manufactured credit events. As noted above, CDS protects against the loss in value of a particular asset, the debt of a reference company. Because protection buyers stand to receive a payout in the event of a default or other specified credit event, they have a reduced incentive to avoid that event (for example, if the buyer is also a creditor to the referenced asset, by loosening underwriting standards), and may even have an incentive to trigger that event. While this is similar to the moral hazard that is present in all insurance transactions, the requirement of an "insurable interest," i.e. a significant stake in the asset being insured, mitigates this.[25] If I have paid $200,000 for my house and insured it against the possibility of destruction by fire, I have very little incentive to let it be destroyed by fire (or to destroy it myself) just to receive that payout, since the payout would only be replacing the money I have already paid for the asset. However, if I can purchase fire insurance on a house that I did not buy and do not otherwise have any economic stake in, then not only do I have no economic incentive to protect the house from burning down, for example by buying and maintaining smoke alarms, **I have an economic incentive to ensure that the house burns down**.

As noted above, there is no insurable interest requirement to enter a CDS—you need not have any exposure whatsoever to the debt of a reference entity to buy CDS "protection" for that debt. As a result, there will be CDS protection buyers with an unmitigated incentive to try to force

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22 15 U.S.C. § 78c-4(f); 7 U.S.C. § 7b-3(h).
23 Release at 28,874.
24 Release at 28,874.
25 Thomas Lee Hazen, *Filling A Regulatory Gap: It Is Time to Regulate over-the-Counter Derivatives*, 13 N.C. BANKING INST. 123, 131 (2009).

the reference entity to experience a credit event that will result in a payout on the CDS. As the SEC points out in the Release, since 2010 (i.e., since the year the Dodd-Frank Act, which finally regulated SBS and other swaps, was passed), these sorts of opportunistic trading strategies, typically referred to as "manufactured credit events" have become prevalent in the CDS market.[26]

As the Release explains, manufactured credit events "can take a number of different forms but generally involve CDS buyers or sellers taking steps, with or without the participation of a company whose securities underlie, or are referenced by, a CDS . . . to avoid, trigger, delay, accelerate, decrease, and/or increase payouts on CDS."[27] One example of such a strategy is a CDS protection buyer inducing a company to default on its debt, typically a minor or technical default that nonetheless results in a payout to the buyer under the CDS.[28] Protection sellers have gotten in on this manipulative game as well, including by inducing companies to temporarily avoid a default until after a CDS expires, to avoid having to make a payout.[29] Whatever form they take, the SEC and other regulators have recognized that manufactured credit events harm the integrity of the markets by, among other things, frustrating the expectations of market participants.[30]

Archegos Capital Management

Just as fraud and manipulation are still prevalent in the SBS market, so does the SBS market continue to pose risks to the broader financial system. This was clearly illustrated in March 2021 when the hidden bets of an obscure trader managing a company called Archegos Capital Management exploded, causing huge losses for banks, driving down the stock prices of several companies, and severely rattling markets. The trader was Bill Hwang, a former manager of a hedge fund that had to settle criminal and civil charges of widespread insider trading.[31]

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26 Release at 6655-56.

27 Release at 6655.

28 Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?,* 94 N.Y.U. L. Rev. 1073, 1094 (2019).

29 Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?,* 94 N.Y.U. L. Rev. 1073, 1094 (2019).

30 Release at 6655; *see also* Gina-Gail S. Fletcher, *Engineered Credit Default Swaps: Innovative or Manipulative?,* 94 N.Y.U. L. REV. 1073, 1104 (2019) (explaining that manufactured credit events harm counterparties to CDS transactions and the public more broadly).

31 Illustrating the absurdity that often accompanies such settlements, only the hedge fund entity, Tiger Asia Management, which is a legal fiction and not a real tangible individual, "admitted" the SEC charges. *See* SEC Press Release, *Hedge Fund Manager to Pay $44 Million for Illegal Trading in Chinese Bank* (Dec. 12, 2012), https://www.sec.gov/news/press-release/2012-2012-264htm. Hwang was allowed to escape personally admitting to the charges. Similarly, notwithstanding some reporting indicating that Bill Hwang pled guilty in his individual capacity, *see* Emily Flitter, et al., *"Tiger Cub" Manager Pleads Guilty in Insider Trading Case*, Reuters (Dec. 12, 2012), https://www.reuters.com/article/us-crime-insidertrading-tiger/tiger-cub-manager-pleads-guilty-in-insider-trading-case-idUSBRE8BB1RG20121212, only Tiger Asia Management actually pled guilty to the criminal charges, or was even charged. *See* Plea Agreement, *U.S. v. Tiger Asia Management,* No. 12-cr-808 (D.N.J. 2012) ("This letter sets forth the plea agreement between your client **Tiger Asia Management, LLC**…and the United States Attorney for the District of New Jersey") (emphasis added). In addition to a fine of $16 million, Tiger Asia Management, which is again a legal fiction,

Instead of shuttering his hedge fund after this malfeasance was revealed, Hwang simply converted it into a "family office," a type of investment adviser that deals with the finances of members of a wealthy family rather than the broader public, enabling it to "take bigger risks" while facing "less regulatory scrutiny."[32] Operating as a family office, Archegos built up huge positions in a number of stocks. However, the positions were not taken by buying the stock outright, but through "total return swaps," which "allow a user to take on the profits and losses of a portfolio of stocks or other assets in exchange for a fee."[33] Total return swaps provide the economic equivalent of actually owning the stock. However, the regulatory treatment is different—Archegos's holdings were large enough that it would have had to have reported its positions had it traded in the actual stock, but because the positions were in total return swaps, they were not required to be reported.[34] Moreover, because they were swaps, Archegos could enter into them using leverage, i.e. borrowed money, which amplified the gains—and losses. This combination of leverage and anonymity proved devastating.

Archegos had large, levered positions in a number of stocks through total return swaps it entered into with a number of banks. When the value of those stocks turned against Archegos, the banks that had helped Archegos lever up began unloading huge blocks of shares of the companies underlying Archegos's total return swaps, causing the share price of those companies to plummet. For example, Discovery closed down 27% on March 19, and ViacomCBS closed down 27% on March 22, 2021. Worse, the panic was not limited to stocks in which Archegos was invested. Because no one knew who was responsible for the massive sell-off, traders were worried that the sell-off reflected sector-wide concerns, causing prices of some peer companies of the companies Archegos was invested in to experience temporary price declines.[35] Moreover, while some of the

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was "sentenced" to one year of probation, which appeared to consist primarily of notifying a probation officer of certain matters, such as change of address or of litigation against the company (apparently no need for drug testing). Criminal Judgment, *U.S. v. Tiger Asia Management*, No. 12-cr-808 (D.N.J. 2012). That Hwang committed millions of dollars worth of fraud in violation of both civil and criminal laws, and was able to escape significant personal liability by pawning off the responsibility on a fictional entity, and then less than 10 years later caused billions of dollars of losses while seriously rattling the markets, perhaps says something about the effectiveness (or lack thereof) of an enforcement regime that consistently "punishes" fictional entities instead of the real individuals who actually commit the crimes those entities are held responsible for, but that is beyond the scope of this comment letter.

[32] Emily Cadman, *How a Blowup at Hwang's Archegos Is Rattling the Finance World*, BLOOMBERG (Mar. 29, 2021), https://www.bloomberg.com/news/articles/2021-03-29/goldman-block-trade-what-to-know-about-bill-hwang-viacom-discovery-stock-sale?sref=mtQ4hc2k.

[33] Quentin Webb, et al., *What Is a Total Return Swap and How Did Archegos Capital Use It?*, Wall St. J. (Mar. 30, 2021), https://www.wsj.com/articles/what-is-a-total-return-swap-and-how-did-archegos-capital-use-it-11617125839.

[34] Quentin Webb, et al., *What Is a Total Return Swap and How Did Archegos Capital Use It?*, Wall St. J. (Mar. 30, 2021), https://www.wsj.com/articles/what-is-a-total-return-swap-and-how-did-archegos-capital-use-it-11617125839.

[35] Emily Cadman, *How a Blowup at Hwang's Archegos Is Rattling the Finance World*, BLOOMBERG (Mar. 29, 2021), https://www.bloomberg.com/news/articles/2021-03-29/goldman-block-trade-what-to-know-about-bill-hwang-viacom-discovery-stock-sale?sref=mtQ4hc2k.

banks that had helped Archegos lever up managed to escape unscathed, others were not so lucky. Credit Suisse lost $4.7 billion, and Nomura lost around $2 billion.[36] As one commenter explained:

> "It's all eerily reminiscent of the subprime-mortgage crisis 14 years ago. Then, as now, the trouble was a series of increasingly irresponsible loans. As long as housing prices kept rising, lenders ignored the growing risks. Only when homeowners stopped paying did reality bite: The banks all had financed so much borrowing that the fallout couldn't be contained."[37]

OVERVIEW OF PROPOSAL

Generally speaking, the Proposal would fulfill the SEC's Dodd-Frank Act mandate to establish rules relating to SBSEFs. Specifically, the Proposal:

- Establishes a registration requirement for SBSEFs, requiring any entity that operates an SBSEF to register as either an SBSEF or a national securities exchange;
- Establish a trade execution requirement for SBS;
- Establish a self-certification process for new product offerings by an SBSEF;
- Establish cross-border exemptions from the SBSEF registration requirement and the trade execution requirement.

The SEC has largely taken the approach of harmonizing the Proposal with the CFTC's rules relating to SEFs.[38]

COMMENTS

The SEC's approach to this Proposal is to "harmonize as closely as practicable with the analogous CFTC rule unless a reason exists to do otherwise."[39] In some respects, this approach makes sense. For example, the statutory requirements applicable to the CFTC with regard to swaps and SEFs are substantially similar to the statutory requirements applicable to SBS and SBSEFs. Moreover, as explained in the Release, the SEC believes that the SEF rules developed by the CFTC have proven to be largely effective:

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36 Erik Schatzker, Sridhar Natarajan, & Katherine Burton, *Bill Hwang Had $20 Billion, Then Lost It All in Two Days*, BLOOMBERG (Apr. 8, 2021), https://www.bloomberg.com/news/features/2021-04-08/how-bill-hwang-of-archegos-capital-lost-20-billion-in-two-days.

37 Erik Schatzker, Sridhar Natarajan, & Katherine Burton, *Bill Hwang Had $20 Billion, Then Lost It All in Two Days*, BLOOMBERG (Apr. 8, 2021), https://www.bloomberg.com/news/features/2021-04-08/how-bill-hwang-of-archegos-capital-lost-20-billion-in-two-days.

39 Release at 28,876.

> "The Commission believes that the CFTC's rules are reasonably designed to implement section 5h of the CEA, which is nearly identical to section 3D of the SEA, and have been effective in practice in facilitating fair, transparent, and competitive trading on SEFs."

Thus, harmonizing with the CFTC's rules makes sense to the extent the CFTC's rules relating to SEFs and swaps execution are based on parallel statutory provisions and are effective in improving the transparency, fairness, and overall functioning of the swaps markets.[40] One good example of this is the CFTC's prohibition on post-trade name give up, which, if allowed, would "deter participation by liquidity seekers on SEFs and SBSEFs."[41] The SEC proposes to follow the CFTC's lead in prohibiting post-trade name give-up because doing so will serve the purposes of Title VII and the public interest: It "will promote pre-trade price transparency by encouraging a greater number, and a more diverse set, of market participants to anonymously post bids and offers on regulated markets."[42] Because it will help serve the public interest, and the purposes of Title VII, harmonizing this provision with the CFTC's analogous prohibition makes sense and should be finalized.

However, the SEC's desire to follow the CFTC's approach is potentially problematic. The Release explains that the SEC seeks to harmonize the two regimes in part to reduce the costs and burdens for market participants.[43] It notes that existing SEFs are likely to be dually registered as SBSEFs and "different or additive requirements" might result in dually registered entities needing to "incur costs and burdens to modify their systems, policies, and procedures to comply with the SEC-specific rules."[44] This approach is misguided to the extent it comes at the expense of the public interest and the need for robust regulation of SBSEFs.

In some instances, and to its credit, the SEC has appropriately rejected consistency in favor of stronger and better rules. For example, as the SEC points out, some key aspects of the CFTC's provisions relating to SEF Core Principles are set out in unenforceable guidance, rather than enforceable rule provisions.[45] To the extent the SEC proposes to adopt provisions from the relevant CFTC guidance, it proposes to do so in enforceable rule provisions, rather than unenforceable guidance, because it believes the provisions of its rule "should be enforceable."[46] This is appropriate, as unenforceable expectations provide comparatively weaker protections. Accordingly, it will be in the public interest for the SEC to depart from the CFTC's approach, as doing so will empower the SEC to actually enforce key provisions of its rule, which in turn will make it less likely that SBSEFs and others will simply ignore the provisions.

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40 BETTER MARKETS, SPECIAL REPORT: TEN YEARS OF DODD-FRANK AND FINANCIAL REFORM 36-37 (2020), https://bettermarkets.org/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf.

41 Release at 28,897.

42 Release at 28,897.

43 Release at 28,876.

44 Release at 28,875.

45 Release at 28,877.

46 Release at 28,877.

In other cases, the Proposal elevates consistency with the CFTC's framework over the public interest and an optimal set of rules governing SBSEFs. In Sections I and II of our comments below, we identify two instances where the SEC proposes to harmonize with CFTC provisions although doing so is inconsistent with Title VII's framework and the public interest. Specifically, the SEC's proposed registration requirement for SBSEFs, which would create in effect an exemption from registration for single-dealer platforms, and the proposal to allow SBSEFs to self-certify new products, would each undermine, if not actually contradict, the requirements of Title VII and the public interest. Accordingly, the SEC must not finalize these provisions as proposed but must revise them to ensure they are consistent with Title VII and the public interest.

As the SEC finalizes the Proposal, it must adhere to this general approach: Harmonizing with the CFTC's rules only to the extent that a credible analysis determines that the CFTC rule will fulfill the letter and spirit of Title VII and robustly protect the public interest.

I. THE SEC'S PROPOSED SBSEF REGISTRATION REQUIREMENT WOULD EXCLUDE SINGLE-DEALER PLATFORMS, VIOLATING THE LETTER AND SPIRIT OF THE SBSEF REGISTRATION MANDATE IN THE DODD-FRANK ACT

The Dodd-Frank Act's registration requirement for SBSEFs is broad and clear, providing that:

> "No person may operate **a facility** for the trading or processing of security-based swaps, unless the facility is registered as a security-based swap execution facility or as a national securities exchange under this section."[47]

In turn, a "security-based swap execution facility" is defined as:

> "a trading system or platform in which **multiple participants have the ability to execute or trade security-based swaps by accepting bids and offers made by multiple participants in the facility or system**, through any means of interstate commerce, including any trading facility, that…facilitates the execution of security-based swaps between persons."[48]

An important thing to note with regard to the statutory registration requirement is that it is not limited by the definition of "security-based swap execution facility," but applies to **any "facility for the trading and processing of swaps."**[49] The **registration requirement itself** is not limited by the defined term "security-based swap execution facility," but rather applies to **any "facility**

47 15 U.S.C. § 78c-4(a)(1) (emphasis added).
48 15 U.S.C. § 78c(a)(77) (emphasis added).
49 15 U.S.C. § 78c-4(a)(1).

for the trading or processing of security-based swaps."[50] Put differently, by its plain terms, the Securities Exchange Act does not only require that those who operate a facility meeting the definition of a "security-based swap execution facility" to register as an SBSEF, but requires anyone who operates a "facility for the trading and processing" of SBS to register **as an SBSEF**, and accordingly to modify their operations, if inconsistent with the definition of an SBSEF, so that it comes into compliance with the definition of an SBSEF. Thus, for example, a person who operated a "facility for the trading or processing" of SBS that allowed one participant to trade SBS by accepting bids or offers made by multiple participants in the facility, under the statutory registration requirement this person would be required to register as an SBS. In addition, it would then be required to change its operations so that it offered multiple-to-multiple trading, consistent with the definition of an SBSEF. Thus, the definition of "security-based swap execution facility" **explicitly does not limit the scope of the registration requirement**, but instead limits the permissible operations of those facilities required to register as SBSEFs.

However, the SEC, proposing to harmonize its SBSEF registration requirement with the CFTC's analogous requirement for SEFs, would repeat the CFTC's own misinterpretation of the similarly structured registration requirement in the Commodity Exchange Act.[51] Specifically, the proposed registration requirement would only apply to a "person operating a facility that offers a trading system or platform in which **more than one market participant has the ability to execute or trade security-based swaps with more than one other market participant on the system or platform**."[52] Thus, like the CFTC before it, the SEC is proposing to conflate the statutory registration requirement, which applies to "any facility for the trading or processing of SBS," with the statutory definition of SBSEF. In turn, this transforms a statutory provision that essentially makes it unlawful for any facility for the trading of SBS to fail to offer multiple-to-multiple trading, into a broad exemption for single-dealer platforms and others that do not offer multiple-to-multiple trading from the registration requirement.

This is directly at odds with the plain language of the Dodd-Frank Act. But this is not simply a legalistic or textualist argument. It is inconceivable, given the context of the Dodd-Frank Act as a reaction to a financial crisis caused in large part by unregulated, opaque SBS and other OTC derivatives, that Congress intended a broad exemption from the SBSEF registration requirements to allow single-dealer platforms to continue to offer SBS trading without any of the protections resulting from the registration requirement and other provisions applicable to SBSEFs that are intended to increase transparency and otherwise ensure that SBS do not contribute to yet another $20 trillion financial crisis. On this issue, the SEC must part company with the CFTC and correctly interpret the Dodd-Frank Act's registration requirement for SBSEFs to avoid creating an

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50 15 U.S.C. § 78c-4(a)(1) (emphasis added).

51 Better Markets Comment Letter on Swap Execution Facilities and Trade Execution Requirement 10-18 (Mar. 15, 2019), https://bettermarkets.org/wp-content/uploads/2021/07/Better-Markets-Comment-Letter-on-Swap-Execution-Facilities-and-Trade-Execution-Requirement_0.pdf.

52 Release at 28,976.

unwarranted, unlawful loophole that subverts congressional intent and endangers the financial system.

II. THE SEC SHOULD NOT ADOPT A SELF-CERTIFICATION PROCESS FOR NEW PRODUCTS

The SEC proposes to establish a self-certification process, whereby SBSEFs can self-certify that a new product complies with the core principles applicable to SBSEFs, as well as all other legal requirements.[53] Under the Proposal, the SEC could object to the self-certification "on the grounds that the product presents novel or complex issues that require additional time to analyze, is accompanied by an inadequate explanation, or is potentially inconsistent with the" Securities Exchange Act or SEC rules.[54] If the SEC stays the certification, it would have an additional 90 days to review the filing, during which the SEC would also be required to provide a 30-day comment period.[55] If the SEC does not stay the self-certification, the new product could be listed after 10 business days.[56]

While this proposed self-certification process does include some improvements to the CFTC's self-certification process, including extending the initial review period from one business day to ten business days, and expanding the scope of reasons for staying the self-certification,[57] it is still fundamentally flawed. The CFTC's self-certification process is **mandated by statute**, as it was added to the Commodity Exchange Act by the deregulatory Commodity Futures Modernization Act of 2000, well before the financial crisis or Dodd-Frank Act.[58] But there is no analogous self-certification provision in the Securities Exchange Act, and of course Congress did not include any such deregulatory provision in the Dodd-Frank Act to apply to SBS or SBSEFs.

In the absence of any statutory mandate analogous to that applicable to the CFTC, the SEC must, at the very least, provide a coherent policy justification for its proposed self-certification process. Unfortunately, the bulk of the policy justification for this aspect of the Proposal is that the rules "should allow SBSEFs to introduce new SBS products to their market places as speedily as practicable while affording the Commission an effective mechanism to assess their consistency" with the requirements of the Securities Exchange Act. While we agree that the Commission must have an effective mechanism for assessing the legality of new products, it is not clear why it is necessary or desirable for SBSEFs to be able to bring new products to the market "speedily." In fact, the Release offers no persuasive justification for the "preliminary belief" that "proposed Regulation SE should allow SBSEFs to introduce new SBS products to their marketplaces as ***speedily as practicable***." In reality, self-certification turns the regulatory process on its head,

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53 Release at 28,882-83.
54 Release at 28,883.
55 Release at 28,883.
56 Release at 28,882.
57 Release at 28,882-83.
58 *See* Lee Reiners, *Bitcoin Futures: From Self-Certification to Systemic Risk*, 23 N.C. BANKING INST. 61, 71 (2019).

creating in effect a presumption of regulatory compliance and putting the onus on the agency, under a predetermined timeline, to fully evaluate a proposed product that may threaten significant harm to investors and market stability.

This is especially the case considering the context in which the SEC was given comprehensive authority to regulate and oversee the SBS market, i.e. a financial crisis caused in large part by SBS and other novel financial products whose risks regulators and market participants thought were well-understood, but in fact were not. Given that context, it makes little policy sense to establish a regime whereby an SBSEF could introduce a new potentially dangerous product to the financial system without an affirmative, independent SEC determination that such product not only complies with the SBSEF core principles and other requirements, but also that it does not pose an unwarranted danger to investors, the financial system, and the broader economy.

III. THE SEC MUST NOT ALLOW CROSS-BORDER EXEMPTIONS TO SWALLOW ITS RULES AND CREATE AN INTERNATIONAL RACE TO THE BOTTOM

The Proposal also addresses cross-border issues related to the trade execution requirement and exemptions from the SBSEF registration requirement for foreign SBS trading facilities.[59] Strong cross-border rules are critical to the protection of the American financial system and economy, as trades booked abroad can transmit enormous risks to U.S. financial institutions, the U.S. financial system, the U.S. economy, and, ultimately, the U.S. taxpayer.

This was illustrated starkly during the financial crisis when the U.S. essentially was forced to bail out the global financial system, and in particular foreign banks and dealers. A prime example of this rescue necessitated by cross-border contagion, was AIG, whose CDS business operated out of London, but which was bailed out by American taxpayers when its risky activities brought it to the brink of collapse.[60] Indeed, the bailout of AIG was, in fact, a bailout of AIG's counterparties, which included multiple foreign banks—of the 22 AIG counterparties bailed out by the U.S. government, 17 were foreign banks.[61] It is for this reason that the Dodd-Frank Act gave the SEC broad authority to establish rules that will prevent cross-border evasion of the SEC's SBS rules, including rules related to SBSEFs.[62]

Positive Elements

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59 Release at 28,922-26.

60 BETTER MARKETS, SPECIAL REPORT: TEN YEARS OF DODD-FRANK AND FINANCIAL REFORM 39-40 (2020), https://bettermarkets.org/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf.

61 Better Markets Comment Letter on Application of Commission Regulation 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 (Mar. 10, 2014), https://bettermarkets.org/wp-content/uploads/2021/07/CFTC-CL-Cross-Border-3-10-14.pdf.

62 15 U.S.C. 78dd(c).

The proposed cross-border provisions contain some positive elements. For example, the SEC proposes to apply the trade execution requirement to a non-U.S. person "whose performance under a security-based swap is guaranteed by a U.S. person" or to a non-U.S. person "who, in connection with its security-based swap dealing activity, uses U.S. personnel located in a U.S. branch or office, or personnel of an agent of such non-U.S. person located in a U.S. branch or office to arrange, negotiate, or execute a transaction."[63] Generally speaking, this is an appropriately broad provision that will help prevent attempted evasion of the trade execution requirement by ensuring that it will apply where there is a significant connection to the U.S., even when neither counterparty is a U.S. person.

<u>The Need to Cover De Facto Guaranteed Entities in the Cross-Border Framework</u>

However, there remains a significant gap in this framework, as it fails to clearly capture activities by non-U.S. persons that are guaranteed by a U.S. person, not through an explicit guarantee but through a de facto guarantee. Such de facto guarantees represent an unspoken but nevertheless powerful arrangement whereby a parent or other U.S. person has a virtually irresistible incentive to cover the losses incurred by another affiliated entity in foreign derivatives transactions. Such an arrangement poses a risk to the U.S. financial system, just as surely as would an explicit guarantee. This is because even when an affiliate lacks an explicit guarantee, it frequently possesses an implicit guarantee, if not on a transaction-by-transaction basis at least on a portfolio level. This is because reputationally, a dealer or large trader in the swaps market simply cannot afford to allow a supposedly non-guaranteed affiliate to fail, except in very marginal cases. The "choice" to let an affiliate or subsidiary fail will inevitably be interpreted as a sign of balance sheet weakness or as a breach of a claimed prior understanding, practice, or expectation. As a result, any large market participant making such a decision will inevitably see a decline in business and order flow, likely precipitously and in very large amounts. In the most extreme case, a failure to bail out an entity that is *de facto* guaranteed can trigger a crisis of market and counterparty confidence, causing a sudden liquidity squeeze, precisely the conditions that caused the near collapse of the financial system post-Lehman bankruptcy.

Indeed, the 2008 financial crisis proved that even formally non-guaranteed affiliates are bailed out when under stress, bringing the risks and liabilities back to the U.S. financial system and proving that cross-border regulation must be applied to them. Citigroup's structured investment vehicles ("SIVs") were just one high-profile example of non-guaranteed subsidiaries that were eventually bailed out by the parent.[22] Citigroup engaged in extensive proprietary trading in the run-up to the crisis, much of which took place through either guaranteed conduits or non-guaranteed SIVs. In 2007, to avoid failure of its guaranteed conduits, Citigroup bought $25 billion of commercial paper that had been issued by its Super Senior conduits and placed those Super Senior securities on the books of the Citigroup commercial bank.[23] Citigroup also "chose" to bring $49 billion of SIV assets onto its balance sheet, **even though it had no legal obligation to do so**, since no guarantee was in place.[24] No distinction was made between the guaranteed subsidiaries

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[63] Release at 29,001.

and the non-guaranteed subsidiaries: Citigroup knew that to allow either to fail would have threatened the very existence of the bank. Beginning in November 2007, Citigroup was forced to recognize huge losses on the Super Senior securities and other positions.[25] By the end of 2008 Citigroup had written off $38.8 billion related to these positions and to asset-backed securities and collateralized debt obligations it held in anticipation of constructing additional collateralized debt obligations.[26] These losses dramatically reduced Citigroup's capital, helped to bring the company to the brink of failure, and required hundreds of billions of dollars in government bailouts. The amount of federal help required to prevent Citigroup from failing was breathtaking, including capital injections, debt guarantees, and asset guarantees.[27] Ultimately, Citigroup received more total aid than any other single entity or firm in connection with the financial crisis: $ 476 billion.[28]

Standards for Assessing Foreign Platforms

The Proposal raises additional concerns relating to foreign trading platforms. The proposed rules relating to exemptions from the SBSEF registration requirement for foreign trading venues and the trade execution requirement may not be robust enough to prevent evasion of those requirements. In particular, the proposed rules relating to these exemptions do not provide meaningful standards for how the SEC will assess requests for such exemptions. As to applications by foreign trading venues for an exemption from the SBSEF registration requirement, the Proposal only explains which statutory definitions the SEC will consider the applicant to be requesting relief from.[64] As to applications for exemptions relating to the trade execution requirement, the Proposal only lists three factors the SEC "may consider" in assessing the application relating to the extent to which various aspects of regulation in the foreign jurisdiction are "comparable" to analogous provisions of U.S. law.[65]

This is insufficient, as it provides the SEC with unreasonably broad, nearly unlimited, discretion, in how it assesses foreign swaps regulatory frameworks. The Dodd-Frank Act requires that the SEC **must**, at the very least, before granting any application for an exemption for foreign trading venues from U.S. requirements relating to SBSEFs, make an affirmative determination that such an application demonstrates that the exemption could not be used to evade those requirements. Making that determination would, in turn, require that the SEC make a credible, comprehensive determination that the foreign regulatory requirements applicable to the applicant, as **actually written, applied, and enforced,** are the same as those that would otherwise apply to the applicant absent an exemption. Absent this clearer and more definitive standard, the SEC may be facilitating evasion of Title VII.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

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[64] Release at 29,001.
[65] Release at 29,001.

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