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Mr. Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre 1155 21st Street NW
Washington, DC 20581

Re: Supplemental Notice of Proposed Rulemaking – Exemption From Derivatives Clearing Organization Registration (RIN 3038-AE65)

Dear Mr. Kirkpatrick:

Milbank LLP appreciates the opportunity to provide comments to the Commodity Futures Trading Commission (the "**Commission**") on its supplemental notice of proposed rulemaking regarding the exemption from derivatives clearing organization ("**DCO**") registration.[1]

We support the Commission's recent actions, including those proposed in the Supplemental DCO Proposal, to make its rules, regulations and practices less burdensome and more conducive to cross-border trading. We are especially glad to see the Commission address in a robust manner one of the more difficult and important aspects of derivatives regulation – the extra-territorial aspects of the Commission's obligation to adequately regulate and supervise the market for cleared derivatives, including cleared swaps, as articulated in Title VII of the Dodd-Frank Act.[2] We believe it is important that the Commission continue to progress this work to ensure that (i) derivatives market participants relying on cross-border transactions have a clear understanding of the applicable regulatory and legal environment; and (ii) the Commission's resources are appropriately targeted at supervision of registered DCOs and protection of US swaps customers.

While there are several aspects of the Supplemental DCO Proposal that may deserve further attention from market participants, we wish to comment here only to endorse one aspect of the proposal – the Commission's decision to require that a U.S. swaps customer clearing a transaction on an exempt DCO do so through a foreign broker rather than through a U.S. futures commission

[1] 84 Fed. Reg. 35456 (July 23, 2019) (the "**Supplemental DCO Proposal**").
[2] The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (the "**Dodd-Frank Act**")

merchant ("**FCM**").[3] Although such a restriction may be commercially undesirable for many market participants, we believe the Commission is acting prudently in acknowledging that its rulemaking authority cannot fully dispel all uncertainty as to how the customer protections of the U.S. Bankruptcy Code (the "**Code**") might be interpreted upon the insolvency of a U.S. FCM if that FCM were clearing customer positions at both registered and exempt DCOs.

As the Commission notes in the Supplemental DCO Proposal, the Code contains protections for customers of insolvent U.S. FCMs, notably provisions entitling an insolvent FCM's "customers" to ratable distribution of "customer property" (as defined in the Code) before such property becomes available to satisfy the claims of the FCM's other creditors.[4] The clarity and certainty of this customer protection regime is further bolstered by the required segregation of the positions and property of different classes of FCM customers (*e.g.* futures vs. swaps).[5] This customer protection regime has proven to be an essential tool in ensuring that, upon the insolvency of a U.S. FCM, the positions of its customers can be ported rapidly and efficiently to other FCMs and those customers' property can be clearly separated from the estate of the FCM (and other classes of customer) and either ported with their positions or returned to the customer with a minimum amount of the confusion (and litigation) that would arise if that property were co-mingled with the estate of the FCM. In our opinion, the Commission is therefore correct to not permit any arrangement that could give the creditors of an insolvent FCM the opportunity to argue that such porting or distributions must be delayed to address competing claims that may arise due to some uncertainty in the legal treatment of any subset of customer positions or property. Unfortunately, as the Commission acknowledged in the Supplemental DCO Proposal, this ***could*** be the case with respect to swaps cleared on exempt DCOs if they were permitted to be cleared through a U.S. FCM.

Under the Code, whether an entity is an FCM "customer" depends on whether such entity's claim against the FCM arises out of or in connection with a "commodity contract," as defined in the Code.[6] The Commission noted in the Supplemental DCO Proposal that one prong of the Code's "commodity contract" definition specifically relates to commodity contracts (futures, foreign futures, etc.) that are cleared through a "clearing organization," which in turn is defined in the Code as a DCO registered under the Commodity Exchange Act (the "**CEA**").[7] Although the CEA was amended to contemplate DCOs that are ***not*** registered under the CEA (*i.e.*, exempt DCOs),[8] the Code was not similarly amended to define "commodity contract" as including contracts cleared through exempt DCOs. In addition, there is no separate prong in the Code's definition of "commodity contract" that explicitly captures "foreign cleared swaps" (while there is one for "foreign futures").[9]

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[3] Supplemental DCO Proposal §3.10(c)(7).
[4] Code Section 766 and Commission Regulation 190.08.
[5] Commission Regulation 30.7.
[6] Code Section 761(4).
[7] Code Section 761(2) and Commission Regulation 190.01(f).
[8] CEA Section 1a(15).
[9] Code Section 761(4).

We note that certain other commenters have argued that the Code could be interpreted so as to bring contracts cleared through exempt DCOs into the definition of "commodity contract."[10] The Dodd-Frank Act added a prong to the Code's "commodity contract" definition covering contracts cleared through registered DCOs and provided for exempt DCOs in the CEA, as noted above, while retaining the Code's prong of the "commodity contract" definition that captures "any other contract, option, agreement or transaction that is similar to a contract, option, agreement or transaction referred to in [the definition of commodity contract]."[11] We also acknowledge that, in the context of a dispute before a U.S. bankruptcy court as to how to interpret these ambiguities in the Code, it would be reasonable to argue that a contract cleared through a foreign central counterparty ("**CCP**") "would appear to be "similar" to a swap cleared through a registered DCO and, therefore, fall within the Code's definition of "commodity contract.""[12] We further acknowledge, as noted by these same commenters, that Section 4d(f)(5) of the CEA (added by the Dodd-Frank Act) provides that "[a] swap cleared by or through a [DCO] shall be considered to be a commodity contract as such term is defined in Section 761 of [the Code], with regard to all money, securities, and property of any swaps customer received by a [FCM] or a [DCO] to margin, guarantee, or secure the swap …."[13] By its express terms, this provision does not distinguish between registered DCOs and exempt DCOs, nor between registered FCMs and exempt FCMs. If, in the face of this parallel statutory language, the Code's definition of "commodity contract" (which was amended by this same section of the Dodd-Frank Act) were construed to exclude swaps cleared through exempt DCOs, Section 4d(f)(5) of the CEA would be superfluous and have no effect. Indeed, it may well be that the better interpretation of Section 761 of the Code is one that includes in the definition of "commodity contract" swaps cleared through all DCOs, whether registered or exempt.

The insoluble problem, unfortunately, is that the Commission (and, for that matter, the other swaps customers of a potentially bankrupt FCM) cannot be certain that the ambiguities at play in the Code on these points will not be exploited by other creditors of the FCM seeking, for their own benefit, to delay or otherwise challenge the rapid and efficient porting or distribution of U.S .swaps customers' positions and property if the relevant estate includes positions (*i.e.*, swaps cleared at exempt DCOs) that (arguably) are not entitled to exactly the same protection as those that are clearly contemplated by the Code.[14] Because the rapid and efficient porting and distribution of

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[10] Appendix A to Futures Industry Association (the "**FIA**") and Securities and Financial Markets Association ("**SIFMA**") comment letter (Oct. 12, 2018) ("**FIA/SIFMA Appendix**"), at 27.
[11] Code Section 761(4).
[12] FIA/SIFMA Appendix, at 27-28.
[13] FIA/SIFMA Appendix, at 28, citing to Section 724(a) of the Dodd-Frank Act.

[14] In *In re Griffin Trading Co.*, 245 B.R. 291, 306-07 (Bankr. N.D. Ill. 2000), for example, a U.K. creditor of a U.S. commodities broker, seeking to enhance its own recovery, succeeded in delaying the distribution of "customer property" to the broker's U.S. customers by more than a year and half. The trustee appointed in the U.S. bankruptcy case (the "Trustee") had sought authority to use all estate assets to pay the claims of Griffin's customers (the "Customer Claims") in full, in priority to all other unsecured creditors, pursuant to the provisions Subchapter IV of the Bankruptcy Code, the CEA, and the rules and regulations of the Commission. *Id.* at 293-94. The Customer

customer property is so central to the protection afforded by this regime, the Commission should do all it can to avoid giving rise to potential disputes over this issue. The clearest and most certain way of doing this is to ensure that swaps cleared at an exempt DCO are not part of the customer property held by the FCM. This is what the Commission has proposed, and we support this decision.

At the same time, we acknowledge that, in light of existing market structure, many market participants would find it preferable to be able to clear swaps on exempt DCOs through a U.S. FCM and that this would likely be a better outcome for the market as a whole if sufficient legal certainty can be achieved. We therefore hope that the Commission will work with Congress to

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Claims all arose through trading activities carried out, if not ordered, in Griffin's London office. *Id.* at 294. If the Trustee's motion were granted, all estate assets would be used to pay the Customer Claims; there would be no assets available for distribution to Griffin's general creditors. *Id.*

The Commission, among many other parties in interest, supported the Trustee's motion. *Id.* However, one general (*i.e.*, non-customer) creditor, MeesPierson N.V. ("MeesPierson"), objected to the motion on, among others, choice of law grounds, arguing that U.K., and not U.S., bankruptcy law should apply to the distribution of estate assets to customers whose claims arose as a result of trades executed in London. *Id.* Under U.S. law, which the Trustee sought to apply, customers receive the highest priority, subject only to payment of certain administrative expenses, in the distribution of segregated customer accounts and other property that is "customer property," a term defined in the Code, and in the CFTC Regulations. *Id.* Under the applicable definitions, only after the administrative expenses and customer claims have been paid in full would "customer property" be available to pay other creditors of the estate. *Id.*

Under English law, by contrast, customer property in segregated accounts never becomes part of the bankruptcy estate, but remains segregated to the customers to the extent that those accounts are actually funded. *Id.* However, if there is a shortfall in those accounts, the injured customer is treated as a general unsecured creditor as to the shortfall. *Id.* at 294-95. Thus, under English law, the customers and MeesPierson would share in a *pro rata* distribution of estate property. *Id.* at 295.

In the end, the *Griffin Trading* court concluded that U.S. law should control for a variety of choice of law and comity-related reasons. *Id.* at 302-06. However, arriving at this outcome consumed a substantial amount of time: (i) the *Griffin Trading* debtor filed the relevant motion in April 1999; (ii) MeesPierson objected to the motion in May 1999; (iii) the remainder of 1999 was consumed with additional briefing and negotiations; (iv) the Bankruptcy Court issued its decision in February 2000; (iv) MeesPierson appealed immediately; and (iv) the appeal remained pending until dismissed as moot in November 2001, after a settlement had been reached. (*In re Griffin Trading Co.*, Case No. 98-41742 (Bankr. N.D. Ill.) [Docket Nos. 73, 90, 113, 119, 133, 154, 161, 163, 165, 185, 192, and 579].) Thus, in the context of the *Griffin Trading* case, a foreign creditor's resort to arguments made possible by a U.S. commodity broker's ability to transact business with both U.S. and U.K. creditors in the U.K. delayed the distribution of assets to the commodity broker's customers for more than a year and a half. Allowing swaps cleared at an exempt DCO to be part the customer property held by U.S. FCMs could give rise to the same or similar scenarios in the future, with comparably problematic consequences. *See, e.g.*, *Securities Investor Protection Corp. v. Bernard L. Madoff Inv. Securities LLC*, 513 B.R. 222 (S.D.N.Y 2014) (non-U.S. transferees arguing successfully that U.S. SIPC trustee should be prohibited from seeking to recover funds that had been transferred from U.S. broker-dealer to certain foreign "feeder fund" customers and, then, to additional foreign transferees because such transfer were "made abroad between a foreign transferor and a foreign transferee"); *Maxwell Communication v. Societe Generale*, 93 F.3d 1036, 1040 (2d Cir.1996) (U.K creditors arguing successfully that U.S. court should defer to UK law for comity reasons and, thus, that U.S. debtor's estate could not recover transfers to U.K. creditors in U.K. under U.S. avoidance laws).

clarify the ambiguity created by (i) the CEA's definition of a DCO (which includes any CCP for swaps) compared to the Code's definition of "clearing organization" (which requires that the DCO be registered with the Commission); and (ii) the lack of a prong for "foreign cleared swaps" in the Code's "commodity contract" definition before permitting U.S. customer positions cleared at an exempt DCO to be cleared through a registered FCM.

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We appreciate the opportunity to provide comments on the Commission's Supplemental DCO Proposal. Please feel free to call the undersigned at (212) 530-5537 with any questions regarding these comments.

Sincerely,

John R. Williams