November 22, 2019

By Electronic Submission

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Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Exemption from Derivatives Clearing Organization Registration (RIN 3038-AE65)

Ladies and gentlemen,

Better Markets, Inc. ("Better Markets")[1] appreciates the opportunity to comment on the Commodity Futures Trading Commission's ("CFTC") supplemental notice of proposed rulemaking setting forth multiple new clearing-related exemptions. Better Markets objects, in particular, to two primary exemptions in the proposal: (1) the exemption from derivatives clearing organization ("DCO") registration and related requirements for certain non-U.S. clearing organizations; and (2) the exemption from futures commission merchant ("FCM") registration and related requirements for non-U.S. persons accepting U.S. customer funds to margin swaps cleared at an exempt clearing organization.[2] These and other elements of the proposal are discussed below.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[3] mandates and encourages migration of significant over-the-counter derivatives risks to U.S. and non-U.S. clearinghouses, making comprehensive supervision and regulation of clearinghouses, clearing practices, and interconnected clearing intermediaries critical to U.S. financial stability. Far from addressing those concerns, the CFTC's proposed unlawful and excessive deference to malleable international recommendations and foreign regulators would be irresponsible and invite, if not guarantee, regulatory arbitrage. Moreover, the proposal, if adopted, would exceed the CFTC's exemptive authority, violate statutory directives, and eliminate the most critical customer and bankruptcy protections for swaps cleared pursuant to the exemptions.

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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, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 84 Fed. Reg. 35456 (July 23, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-07-23/pdf/2019-15258.pdf.

3 Pub. L. 111–203, 124, Stat. 1376 (2010).

For these reasons, and others, the CFTC must promptly withdraw the proposal, abandon its pursuit of unnecessary and unlawful exemptions, and refocus its regulatory efforts on statutory public interest mandates to ensure the protection of U.S. customer funds, the safety and soundness of swaps intermediaries, and the financial stability of the U.S. financial system, as well as fair competition across cleared swaps markets.[4]

I. To validly exercise exemptive authority, the CFTC is statutorily required to determine that a non-U.S. clearing organization is subject to supervision and regulation that is comparable to, and as comprehensive as, the U.S. supervision and regulation that otherwise would apply to such organization.

Non-U.S. clearing organizations[5] facilitating swaps clearing for U.S. persons, including U.S. customers,[6] are required to register as DCOs. Section 5b(a)(1)(B) of the Commodity Exchange Act ("CEA") provides that "it shall be unlawful for a [DCO], directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce to perform functions of a DCO with respect to . . . a swap."[7] CEA section 2(i) provides that activities outside of the U.S. are subject to the CEA's swap-related provisions if they have a direct and significant connection with activities in, or effect on, U.S. commerce, or contravene CFTC regulations established to prevent evasion of provisions enacted by the Dodd-Frank Act.[8] Read together, these CEA provisions require DCO registration of any non-U.S. clearing organization whose swaps clearing activities have a direct and significant connection with activities in, or effect on, U.S. commerce, including any organization's clearing activities that involve or have effects on U.S. counterparties or U.S. intermediaries. Under CEA section 5b(c)(2)(A)(i), "[t]o be registered and maintain registration as a [DCO],"[9] non-U.S. DCOs, like others, must comply with statutory DCO core principles

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4 See 7 U.S.C. § 5(b) (providing that the CFTC's administration of the CEA is intended "to deter and prevent . . . disruptions to market integrity; to ensure the financial integrity of all transactions . . . and the avoidance of systemic risk; to protect all market participants from . . . misuses of customer assets; and to promote . . . fair competition among boards of trade, other markets and market participants").

5 The CFTC's proposed regulations would not use or define the term, "non-U.S. clearing organization," but rather would limit exemptive relief to clearinghouses "organized outside of the United States." See Proposed § 39.6 ("The Commission may exempt a derivatives clearing organization that is organized outside of the United States, from registration as a derivatives clearing organization for the clearing of swaps for U.S. persons . . . .") (emphasis added); See also Proposed § 39.2 ("*Good Regulatory Standing* means, with respect to a clearing organization that is organized outside of the United States, and is licensed, registered, or otherwise authorized to act as a clearing organization in its home country . . . .") (emphasis added). We note the distinction between the proposed exemption for certain non-U.S. clearing organizations, which focuses on whether an eligible clearinghouse is "organized" outside of the U.S., and the proposed exemption for certain clearing intermediaries, which focuses on whether an intermediary is "located" outside of the U.S. See Proposed § 3.10 ("A person located outside the United States, its territories or possessions is not required to register . . . .") (emphasis added).

6 See 17 C.F.R. § 1.3. In the present context, the term, "U.S. customer," would include any U.S. person that is not a clearing member of an exempt clearing organization and that clears swaps at such organization through an unaffiliated clearing member. See, e.g., Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 84 Fed. Reg. 35456, 35458 (July 23, 2019).

7 7 U.S.C. § 7a–1(a)(1)(B).

8 7 U.S.C. § 2(i).

9 7 U.S.C. § 7a–1(c)(2)(A)(i).

and "any [DCO] requirement that the [CFTC] may impose by rule or regulation,"[10] including applicable part 39 regulations.[11]

CEA section 5b(h) provides the CFTC authority to exempt a non-U.S. clearing organization from DCO registration, conditionally or unconditionally, with respect to swaps clearing, provided such organization is subject to "comparable, comprehensive supervision and regulation" by an appropriate governmental authority in its home country.[12] However, this statutory exemptive authority is not without limit or subject to the CFTC's unfettered discretion. In accordance with CEA section 5b(h)'s plain language, DCO registration exemptions require the following elements be met as part of any exemptive determination:

- First, there must be supervision and regulation of the non-U.S. clearing organization;
- Second, such non-U.S. clearing organization must be supervised and regulated by an appropriate governmental authority;
- Third, such appropriate governmental authority must be in the home country of the clearing organization;
- Fourth, such supervision and, separately, regulation must be comparable to supervision and regulation of U.S. registered DCOs; and
- Fifth, such supervision and, separately, regulation must be comprehensive, meaning each must cover the full panoply of clearing areas and requirements applicable to CFTC-registered DCOs.

The CFTC must have a reasonable basis to conclude that each of these elements has been met for any exercise of exemptive authority to be valid. Most critically, though, the CFTC must have a reasonable basis to conclude that requirements in a non-U.S. clearing organization's applicable foreign regulatory framework are comparable to, and as comprehensive as, requirements in the **U.S. statutory and regulatory** framework applicable to DCOs.

The CFTC nevertheless proposes to exempt certain non-U.S. clearing organizations without so much as a reference to or analysis of a non-U.S. clearing organization's home country laws relative to U.S. statutory and regulatory requirements, in clear contravention of the statutory requirements for a valid exercise of CEA section 5b(h) authority. This is true, moreover, not only with respect to the present proposal but also the related 2018 exempt clearing organization proposal[13] and the four exemptive orders

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[10] Id.

[11] 17 C.F.R. Part 39. See Commodity Futures Trading Commission, Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69334 (Nov. 8, 2011), available at https://www.govinfo.gov/content/pkg/FR-2011-11-08/pdf/2011-27536.pdf.

[12] 7 U.S.C. § 7a–1(h).

[13] In 2018, the CFTC proposed a regulatory framework for administering exemptions from DCO registration for non-U.S. clearing organizations facilitating proprietary swaps clearing for U.S. persons and FCMs. See Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 83 Fed. Reg. 39923 (Aug. 13, 2018) ("2018 Exempt DCO Proposal"), available at https://www.govinfo.gov/content/pkg/FR-2018-08-13/pdf/2018-17335.pdf.

already issued pursuant to CEA section 5b(h).[14] The CFTC proposes, instead, that a non-U.S. clearing organization merely be organized in a jurisdiction in which it is subject to statutes, regulations, and policies determined collectively to be ***consistent with international standards*** published in the 2012 Principles for Financial Markets Infrastructures ("PFMIs").[15] The CFTC carefully explains its CEA section 5b(h) exemptive authority as follows:

> As the Commission is statutorily required to determine that a non-U.S. clearing organization is subject to "comparable, comprehensive supervision and regulation" by a home country regulator to be eligible for an exemption from DCO registration, the Commission would be required to modify or terminate an exemption upon a subsequent determination that the home country regulator's supervision and regulation no longer meets ***that standard***.[16]

We agree. However, under CEA section 5b(h), ***that standard*** turns on whether supervision and regulation in a non-U.S. jurisdiction is comparable to, and as comprehensive as, the U.S. requirements applicable to DCOs.

The CFTC's contrary interpretation of CEA section 5b(h) is explained in the 2018 Exempt DCO Proposal.[17] There, the CFTC states that it has "construed 'comparable, comprehensive supervision and regulation' to mean that the home country's supervisory and regulatory framework should be consistent with, and achieve the same outcome as, the **statutory and regulatory requirements** applicable to registered DCOs."[18] However, the CFTC further explains that "a supervisory and regulatory framework that conforms to the [PFMIs]" should be deemed "comparable to, and as comprehensive as, the supervisory

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[14] The CFTC has exempted four non-U.S. clearing organizations from registration requirements with to the clearing of proprietary swaps for U.S. persons and FCMs. See ASX Clear (Futures) Pty Amended Order of Exemption from Registration, In the Matter of the Petition of ASX Clear (Futures) Pty Limited For Exemption from Registration as a Derivatives Clearing Organization (Jan. 28, 2016); Korea Exchange, Inc. Order of Exemption from Registration, In the Matter of the Petition of Korea Exchange, Inc. For Exemption from Registration as a Derivatives Clearing Organization (Oct. 26, 2015); Japan Securities Clearing Corporation Order of Exemption from Registration, In the Matter of the Petition of Japan Securities Clearing Corporation For Exemption from Registration as a Derivatives Clearing Organization (Oct. 26, 2015); OTC Clearing Hong Kong Limited Order of Exemption from Registration, In the Matter of OTC Clearing Hong Kong Limited For Exemption from Registration as a Derivatives Clearing Organization (Dec. 21, 2015).

[15] Committee on Payment and Settlement Systems, Technical Committee of the International Organization of Securities Commissions, Principles for financial market infrastructures (April 2012), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD377-PFMI.pdf. See also Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 84 Fed. Reg. 35456, 35460 (July 23, 2019) (providing that exempt clearing organizations need not comply with the April 2012 PFMIs "as updated, revised or otherwise amended," a previously proposed requirement that should be reinstated should the CFTC proceed with the proposal).

[16] Id at 35463.

[17] See fn. 13 supra. Better Markets requests that the CFTC incorporate these comments into the rulemaking record for the 2018 Exempt DCO Proposal.

[18] See Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 83 Fed. Reg. 39923, 39924 (Aug. 13, 2018) (emphasis added). That "consistency" standard and "outcomes-based" analysis is itself a recharacterization of CEA section 5b(h)'s exemptive standard. To be sure, it requires an assessment of a foreign regulatory framework relative to U.S. law in certain respects. However, Congress could and undoubtedly would have provided the interpretive flexibility attendant to the "consistency" and "outcomes-based" exemptive standards if it determined it necessary or advisable; it instead provided a statutory standard focused on comparable, comprehensive supervision and regulation, which is not necessarily consistent with the CFTC's formulation. Nevertheless, the CFTC's key acknowledgement, for present purposes, is that U.S. statutory and regulatory requirements must be considered with respect to any valid exercise of CEA section 5b(h) exemptive authority.

and regulatory requirements applicable to DCOs."[19] **In essence, then, the CFTC unlawfully proposes not to consider whether foreign clearinghouse supervision and regulation is comparable to, and as comprehensive as, *U.S. law*.** It proposes, in essence, that the 2012 PFMIs constitute the equivalent of U.S. law for purposes of CEA section 5b(h) determinations, which is plainly incorrect as a matter of statutory interpretation.[20]

The CFTC cannot be excused from the analysis required by CEA section 5b(h). In the first instance, CEA section 5b(h) is applicable only if a non-U.S. clearing organization is subject to CEA section 5b(a)'s DCO registration requirement and therefore is required to comply with the full panoply of DCO requirements.[21] That is why Congress, in setting forth the required CEA section 5b(h) exemptive analysis, logically instructed the CFTC to consider whether a foreign clearinghouse's supervisory and regulatory framework is comparable to, and as comprehensive as, U.S. statutory and regulatory requirements *otherwise applicable* to the organization. If the CFTC is determined to effect shortsighted exemptions, it must at least do so pursuant to the statutorily required processes for considering these *otherwise applicable* U.S. requirements.

In any event, U.S. statutory and regulatory DCO requirements are not the equivalent of the PFMIs. The PFMIs merely set forth aspirational principles and responsibilities with respect to the regulation of clearinghouses that, while helpful and perhaps consistent with U.S. law, do not have the force of law until implemented by governmental authorities.[22] The PFMIs constitute, at most, international recommendations to be implemented by the CFTC and other regulators, not clearing organizations themselves,[23] meaning that clearing organizations are governed by them only if and as implemented, usually with material variations, by the U.S. and other PFMI-compliant jurisdictions. **International recommendations without the force of law, even if masquerading as agreed upon "standards," cannot be deemed comparable to CEA provisions and CFTC regulations imposing specific requirements on non-U.S. clearing organizations.[24]**

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19 Id.

20 The logic appears to be that if the CFTC judges A to equal B and B to equal C, the CFTC can permit clearinghouses to ignore the requirements of A (even though CEA section 5b(h) requires clearinghouses to comply with an equivalent of A) and instead to comply solely with C, a framework determined equivalent to B. The CEA does not contemplate the substitution of statutory standards according to the transitive property, however, and in reality, the PFMIs cannot be reasonably viewed as the equivalent of U.S. law.

21 Obviously, if a non-U.S. clearing organization is not subject to the DCO registration requirement, the CFTC's reliance on CEA section 5b(h)'s exemptive authority would be unnecessary.

22 The CFTC's conclusion that a non-U.S. clearing organization is subject to foreign clearinghouse requirements that are consistent with the PFMIs would not necessarily conflict with a similar, though not identical, conclusion that such organization is subject to foreign requirements that are comparable to the CEA's statutory DCO core principles and applicable part 39 and other regulations. But, again, the former is not the statutorily required determination for the CFTC to validly exercise exemptive authority under CEA section 5b(h).

23 Indeed, the Committee on Payment and Settlement Systems and the Board of the International Organization of Securities Commissions monitor implementation of the PFMIs by examining progress in G20 jurisdictions' legal and regulatory frameworks.

24 For these reasons, the CFTC's orders exercising CEA section 5b(h) exemptive authority are fatally flawed as well. See fn. 14 supra. The CFTC currently permits certain U.S. persons to clear proprietary swaps at four exempt clearing organizations based on conclusory statements about the relevant foreign regulatory frameworks' consistency with the PFMIs. Separate and apart from impermissibility of using the PFMIs as the applicable statutory baseline for CEA section 5b(h) exemptive authority, the CFTC provides literally no analysis to support its conclusion that applicable statutes and regulations are comparable to and as comprehensive as the PFMIs. Neither the scope of the relevant regulatory frameworks nor the comparability of any provision relating to legal, regulatory, or policy issues—such as model risk management, default management, position porting, or guarantee fund sizing—is mentioned. The CFTC simply concludes that the four petitioners for exemptive relief have "demonstrated

II. The CFTC's proposed exemption for intermediaries facilitating U.S. customer swaps cleared through exempt clearing organizations exceeds its CEA section 4(c) exemptive authority and eliminates the CEA's most critical customer protections.

Under the CFTC's interpretation of CEA section 4d(f),[25] intermediaries facilitating U.S. customer swaps clearing through registered or exempt non-U.S. clearing organizations are required to register as FCMs.[26] CEA section 4d(f), by its terms, provides only that "[i]t shall be unlawful for any person [that is not registered as an FCM] to accept any money, securities, or property (or to extend any credit in lieu of money, securities, or property) from, for, or on behalf of a swaps customer to margin, guarantee, or secure a swap cleared by or through a [DCO]."[27] However, the CFTC reasonably construes CEA 4d(f) to require FCM registration of any persons accepting money, securities, or property (or extending such credit) from, for, or on behalf of a U.S. customer to margin, guarantee, or secure swaps cleared through a clearing organization that would have to register as a DCO in the absence of the valid exercise of CEA section 5b(h) authority.

There are two fundamental concerns with respect to the CFTC's proposed exemption from the above FCM registration provision. First, the CEA section 4(c) exemptive authority relied upon by the CFTC to effect the FCM-registration exemption does not extend to CEA section 4d(f). That, in itself, requires the CFTC to withdraw or at least re-propose that element of the proposal. But even if CEA section 4(c) did extend to the FCM-registration provision (and, again, it does not as explained below), the CFTC's proposed exercise of CEA section 4(c) exemptive authority raises significant and widely acknowledged bankruptcy and other customer protections issues that strongly counsel for withdrawal of the contemplated framework.

A. The CFTC's proposed exemption for intermediaries clearing U.S. customer swaps through exempt non-U.S. clearing organizations exceeds its CEA section 4(c) exemptive authority.

The CFTC unlawfully proposes to rely upon CEA section 4(c) exemptive authority to exempt intermediaries clearing U.S. customer swaps through exempt clearing organizations from CEA section 4d(f). CEA section 4(c) is not a model of statutory clarity, but it limits general exemptive authority to the following:

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compliance with those requirements of the Act with which it must comply to be eligible for an exemption from registration as a DCO." Id. We struggle to understand the legally cognizable rationale for this secrecy, concession of the CFTC's authority, and violation of the CEA's unambiguous statutory commands. Unlike a registration application, for example, CEA section 5b(h)'s analysis requires consideration only of publicly available information—statutes, regulations, guidance, and policies—not commercially sensitive information frequently kept from public view in registration orders.

[25] 7 U.S.C. § 6d(f).

[26] Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 84 Fed. Reg. 35456, 35458 (July 23, 2019) ("In order to permit foreign intermediaries to clear swaps for U.S. persons, the Commission is proposing to exercise its authority under section 4(c) of the CEA to exempt foreign intermediaries from the prohibition in section 4d(f) of the CEA against accepting customer funds to clear swaps at a ***registered or exempt*** DCO without registering as FCMs.") (emphasis added). Intermediaries soliciting and accepting orders and providing trading advice in connection with U.S. customer swaps cleared through non-U.S. clearing organizations also are required to register as commodity trading advisors ("CTAs"). CEA section 4m provides that "[i]t shall be unlawful for any [unregistered] [CTA]. . . to make use of the mails or any means or instrumentality of interstate commerce in connection with his business as a [CTA]." 7 U.S.C. § 6m(1). CEA section 1a(12) defines CTA to mean "any person who . . . for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in . . . any . . . swap." 7 U.S.C. § 1a(12)(A)(i)(I).

[27] 7 U.S.C. § 6d(f).

> "[A]ny agreement, contract, or transaction (or class thereof) that is ***otherwise subject to [CEA section 4(a)]*** (including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction)."[28]

CEA section 4(a), in turn, prohibits any person from entering into off-exchange futures contracts "[u]nless exempted by the [CFTC] pursuant to [CEA section 4(c)]."[29] CEA section 4(a) itself also contains a statutory exclusion from its requirements for ***contracts*** "made on or subject to the rules of a board of trade, exchange, or market located outside of the United States."[30] For present purposes, however, it is sufficient to note that the term "swap" cannot be read into the phrase "contract for the purchase or sale of a commodity for future delivery" that precedes the parenthetical exclusion containing the term "contract," as that phrase establishes the scope of CEA section 4(a) and is explicitly excluded from the "swap" definition in CEA section 1a(47)(B)(i).[31]

Accordingly, CEA section 4(c)'s exemptive authority cannot be used to exempt foreign swaps intermediaries from the FCM registration requirement; doing so would extend CEA section 4(c)'s exemptive authority to persons rendering services with respect to agreements, contracts, or transactions that are <u>not</u> "otherwise subject to [CEA section 4(a)]."[32]

Notwithstanding CEA section 4(c)'s plain language limitations, some may contend that the CFTC should read the phrase "otherwise subject to [CEA section 4(a)]" out of the statute and interpret CEA section 4(c) to contemplate swaps-related exemptive authority at least with respect to enumerated provisions in CEA section 4(c)(1)(A)(i)(I).[33] That would require a tortured and unlawful interpretation of the CEA section 4(c)'s clause setting forth exceptions to the CFTC's general exemptive authority. The relevant provisions in CEA section (c)(1) provide that the CFTC can exempt any "agreement, contract, or transaction (or class thereof) that is otherwise subject to [CEA section 4(a)] . . . from any provision . . . (***except*** [certain subparagraphs] . . . ***except*** that—***unless*** the [CFTC] is expressly authorized by any provision, with respect to amendments made by [Title VII of the Dodd-Frank Act], with respect to [certain enumerated provisions]."[34] Thus, setting aside the CEA section 4(a) limitation, the statutory exception-to-the-exception might be read to bring back into scope for the CFTC's exemptive authority only the ***enumerated provisions*** in CEA section 4(c)(1)(A)(i)(I). Those provisions, however, do not include CEA section 4d(f)—the provision requiring FCM registration in connection with certain swaps activities—and yet do include related CEA section 4d provisions, indicating Congress deliberately excluded FCM registration from the CFTC's exemptive authority.[35]

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28 7 U.S.C. § 6(c)(1) (emphasis added).

29 7 U.S.C. § 6(a).

30 <u>Id.</u>

31 7 U.S.C. § 1a(47)(B)(i) (setting forth an exclusion from the "swap" definition for "any contract of sale of a commodity for future delivery").

32 7 U.S.C. § 6(c)(1).

33 7 U.S.C. § 6(c)(1)(A)(i)(I).

34 <u>Id</u> (emphasis added).

35 <u>See</u> 7 U.S.C. § 6(c)(1)(A)(i)(I) (referencing, among other provisions, 7 U.S.C. §§ 6d(c) and 6d(d) but not 7 U.S.C. § 6d(f)).

Thus, in either interpretation above, CEA section 4(c) cannot be reasonably read to contemplate CFTC exemptive authority with respect to FCM registration in connection with swaps clearing activities. Indeed, it is best read not to contemplate an exemption with respect to swaps activities at all. But even if the CFTC were to determine that it does, CEA section 4(c) at least cannot be reasonably read to apply to any provision other than an enumerated provision in CEA section 4(c)(1)(A)(i)(I), which does not include CEA section 4d(f).

B. The CFTC's proposed exemption for intermediaries facilitating U.S. customer swaps cleared through exempt clearing organizations unlawfully eliminates the CEA's most critical customer protections.

The scope of the FCM registration requirement under CEA section 4d(f) is a critical interpretive issue, because FCM registration carries with it a number of statutory and regulatory requirements intended to protect U.S. customer funds, including segregation, capital, reinvestment, and financial reporting requirements. Indeed, the CFTC implemented significant improvements to U.S. customer protections in the aftermath of the Peregrine Financial Group, Inc. ('PFG") and M.F. Global, Inc. ("MFG") failures, each of which involved a significant loss of U.S. customer funds. Those failures demonstrate the critical importance of U.S. bankruptcy law protections for U.S. customers of FCMs, especially with respect to claims priority.

In the PFG case, Russell R. Wasendorf, Sr., PFG's owner and chief executive officer, misappropriated at least $215 million in customer funds from 13,000 U.S. customers by unlawfully withdrawing funds from the FCM's segregated customer accounts.[36] For decades, Wasendorf inflated FCM segregated customer balances on forged bank statements—which included a false P.O. Box to intercept regulatory communications to the bank that held the segregated account—and then used the fraudulent bank statements as a basis for filing false periodic FCM reports with the CFTC and the National Futures Association. PFG filed for bankruptcy once the extent of the fraud became known, as is inevitable in large scale misappropriation cases, leaving U.S. customers dependent on the U.S. bankruptcy framework to recover a percentage of losses.[37]

Less than one year earlier, U.S. customers had a similar fate when MFG raided segregated funds in the lead-up to its bankruptcy. MFG reportedly "leveraged more than $1 billion of customer funds into its own enormously risky $6.3 billion repo bet on European sovereign debt," but "[o]nce MF Global disclosed the risky trades on European sovereign debt, revealed associated margin calls, and announced significant financial losses for the quarter, the firm collapsed abruptly with an estimated $1.6 billion in customer funds missing."[38] This left MFG's customers dependent on the U.S. bankruptcy framework to recover a percentage of losses as well.

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36 See, e.g., U.S. Attorney's Office, Peregrine Financial Group CEO Sentenced to 50 Years for Fraud, Embezzlement, and Lying to Regulators (Jan. 31, 2013), available at https://archives.fbi.gov/archives/omaha/press-releases/2013/peregrine-financial-group-ceo-sentenced-to-50-years-for-fraud-embezzlement-and-lying-to-regulators.

37 On July 10, 2019, a U.S. district court issued an order appointing a temporary receiver, which also authorized the receiver to "[i]nitiate [a] bankruptcy proceeding on behalf of Defendant Peregrine Financial Group, Inc." See United States District Court, Northern District for Illinois, U.S. Commodity Futures Trading Commission v. Peregrine Financial Group, Inc. and Russel R. Wasendorf, Sr., Order Appointing a Temporary Receiver, Civil Action No. 1:12-cv-05383 (July 10, 2012), available at https://www.cftc.gov/sites/default/files/groups/public/@lrenforcementactions/documents/legalpleading/enfperegrineorder071012.pdf.

38 L. Goldsmith, The Collapse of MF Global and Peregrine Financial Group: The Response from the Futures Industry, Regulators, and Customers, Developments in Banking Law, 25, 26 (2012-13).

These examples demonstrate the importance of U.S. bankruptcy protections to U.S. customers, but a number of additional FCM requirements both facilitate disposition of an FCM's assets in bankruptcy and prevent bankruptcy in the first place. For example, FCMs must hold "at all times" a sufficient amount of money, securities, and/or property in designated customer segregated accounts to satisfy the FCM's total outstanding obligation to each customer engaging in cleared swap transactions.[39] In addition, FCMs are prohibited from commingling customer money, securities, and property with the FCM's own funds and from using such money, securities, and property "to margin, secure, or guarantee any trades or contracts of any swaps customer or person other than the person for whom the same are held."[40] **These critical provisions, and others, collectively insulate U.S. customers and their property from risks arising from an FCM's proprietary trading and other operations and facilitate recovery in the event of an FCM's unexpected failure.**

As we mentioned above, the CFTC unlawfully proposes not only to exempt certain swaps-related intermediaries from registration under CEA section 4d(f)[41] but also to exempt them from "all other provisions and regulations applicable to FCMs,"[42] including minimum capital, segregation, and financial reporting requirements.[43] Moreover, it proposes to do so without consideration of any supposedly comparable protections in non-U.S. jurisdictions. Thus, it would indefensibly deny U.S. customers the CEA's most critical statutory protections without a substitute framework to mitigate any risks arising from the proposal.[44] Equally importantly, and perhaps more practically, the lack of U.S. bankruptcy and customer protections would deter many, if not most, U.S. customers from relying on the proposed framework. In other words, the CFTC proposes to create a host of problems as part of a solution in search of a problem.

The CFTC acknowledges, in fact, that the proposed prohibition on FCM registration is intended to address "uncertainty of how customer funds held by the FCM to margin swaps cleared at an exempt DCO would be treated under a bankruptcy proceeding."[45] In other words, the CFTC proposes to wholly eliminate

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[39] See also 17 C.F.R. 22.2(f)(4) (setting forth requirements for FCM treatment of cleared swaps and associated cleared swaps customer collateral). In addition, FCMs must "treat and deal" with swaps customer money, securities, or property received to margin, guarantee, or secure a cleared swap as belonging to the FCM's swaps customer, not the FCM itself or its other customers. 7 U.S.C. § 6d(f)(2)(A). See also 17 C.F.R. 22.3(a).

[40] 7 U.S.C. § 6d(f).

[41] Proposed §3.10(c)(7)(i).

[42] See Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 84 Fed. Reg. 35456, 35458 (July 23, 2019).

[43] See Id ("The purpose of this proposed provision is to clarify that the foreign intermediary would be exempt not only from the registration requirement of section 4d(f) of the CEA, but also from all other provisions and regulations applicable to FCMs, including regulations regarding the holding of customer segregated funds and FCM capital and financial reporting requirements.").

[44] The CFTC also proposes to permit intermediaries exempted from FCM registration to provide trading advice to U.S. persons with respect to swaps cleared by exempt clearing organizations without registering as a commodity trading advisor. Proposed § 3.10(c)(7)(v). CFTC Regulation § 1.3, 17 CFR 1.3, provides that a CTA is "any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading in any contract of sale of a commodity for future delivery, security futures product, or swap. See also 7 U.S.C. 1a(12).

[45] Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 84 Fed. Reg. 35456, 35458, fn. 17 (July 23, 2019). The CFTC also acknowledges that the proposal would introduce "uncertainty as to whether, in the event of an FCM bankruptcy proceeding, swaps customers funds deposited at exempt DCOs, or margining swaps cleared at exempt DCOs, would be treated as customer property under the Bankruptcy Code to the same extent as if they were deposited at a registered DCO." Id at 35461.

the FCM customer protection frameworks in order to avoid bankruptcy uncertainty and the potential for U.S. customers to wrongly think they can rely upon them.[46]

In place of the CEA's U.S. customer protections, the CFTC simply would require exempt clearing organizations to implement rules requiring clearing members to provide U.S. customers with a "written notice" containing three statements:

(1) The clearing member is not a registered FCM;

(2) The clearing organization is exempt from registration; and

(3) The protections of the U.S. Bankruptcy Code do not apply to the U.S. person's funds.[47]

The CFTC also proposes that the notice compare bankruptcy and other protections available under U.S. law and the home country regulatory regime, apparently based on the belief that U.S. customers will have the resources, expertise, and time to review technical legal templates relating to differences in bankruptcy law across jurisdictions. The CFTC claims that this requirement would serve as notice to U.S. persons of "the standards and risks that would apply in the exempt DCO's home country with respect to clearing through the non-FCM clearing member and the exempt DCO."[48] That much is true. However, that notice almost certainly will not be *effective* notice.

The CFTC's notice-based proposal is driven by the same caveat emptor philosophy that not long ago placed far too much confidence in derivatives dealers and their "customers" (read, *counterparties*) to rein in excesses in lead-up to the 2008 financial crisis. Written notices are a minimal—perhaps the most minimal—protection for U.S. customers, and in this case, the notice itself merely lets the U.S. customer know that it should not expect to be protected. Moreover, history is replete with examples of U.S. customers having little concern about bankruptcy matters until intermediaries approach the zone of insolvency. In other words, the notice probably won't matter until it does—the precise time that it will be of minimal value.

The CFTC rightly acknowledges that it cannot propose an exempt clearing organization framework that retains FCM clearing for U.S. customers without introducing, at a minimum, uncertainties with respect to the treatment of customer funds in bankruptcy. It proposes to determine, therefore, that FCMs must be prohibited from facilitating U.S. customer clearing at exempt clearing organizations. But the far more defensible policy—consistent with longstanding CFTC and CFTC staff views on swaps clearing at exempt clearing organizations—would be to **prohibit U.S. customer clearing at exempt clearing organizations altogether**, which, to date, in no way has diminished the value, liquidity, or attractiveness of U.S. cleared swaps markets.

In this regard, the primary issue should not be whether "the Bankruptcy Code [can] be read to permit swaps customer funds to be deposited at an exempt DCO by an FCM directly, or through a foreign member of the exempt DCO, and still receive the same protections as swaps customer funds deposited at a

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46 The noted bankruptcy-related "uncertainty" is not a consequence of the law, of course, but of the CFTC's decision to entertain U.S. customer swaps clearing through exempt clearing organizations and unregistered intermediaries.

47 Proposed § 39.6(b)(2).

48 Commodity Futures Trading Commission, Exemption from Derivatives Clearing Organization Registration, 84 Fed. Reg. 35456, 35462 (July 23, 2019).

registered DCO,"[49] as the CFTC frames it. The issue should be whether the CFTC is **certain** that U.S. customers receive the "same protections as swaps customer funds deposited at a registered DCO" through an FCM. If there is any reasonable doubt about that proposition (and there is no doubt that there is ample reasonable doubt), the CFTC must, consistent with statutory mandates and statutory limits on exemptive authority, continue to apply U.S. law directly. That means U.S. customers should be required to clear swaps through FCMs and DCOs, as they have successfully done in the decade or so since the passage of the Dodd-Frank Act.

III. The "substantial risk" test in the present proposed rulemaking is fatally flawed, as we explained in connection with the proposed "alternative compliance' framework for non-U.S. DCOs.

The CFTC's proposal would exempt only those non-U.S. DCOs that the CFTC has not determined to pose "substantial risk to the U.S. financial system."[50] This proposed "substantial risk" framework for exempt clearing organizations is identical to the proposed "substantial risk" framework applicable to DCOs eligible for "alternative compliance." In section III of our comment letter addressing the CFTC's proposed "substantial risk" test in the context of the "alternative compliance' framework, Better Markets discussed at length a number of concerns with respect to the proposed exclusion of certain non-U.S. clearing organizations from the "alternative compliance" framework. Those concerns are equally applicable to the "substantial risk" test in this context. Therefore, we hereby incorporate the full text of Better Markets' Letter on Registration with Alternative Compliance for Non-U.S. Derivatives Clearing Organizations (RIN 3038-AE87) (November 18, 2019).[51]

V. Conclusion

The CFTC's proposal unlawfully and irresponsibly would encourage unregistered foreign clearinghouses and unregistered foreign clearing members to facilitate U.S. customer swaps clearing without critical U.S. customer protections. It would deliberately place certain foreign clearinghouses and their clearing members beyond the CFTC's direct oversight. And it would permit U.S. persons to meet U.S. clearing mandates through exempt intermediaries facilitating clearing in exempt clearing organizations (and presumably with time, perhaps even to use exempt swap execution facilities to execute the cleared swaps with unregistered dealers).[52] The proposal therefore represents a shocking, indefensible, and unlawful retreat from the CFTC's statutory mandate and an unreasonable capitulation to foreign regulatory and commercial interests.

For these reasons, any final regulations would not only be susceptible to legal challenge—they would command it.

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49 Id at 35464.

50 See Proposed § 39.6(a)(2).

51 Better Markets' Letter on Registration with Alternative Compliance for Non-U.S. Derivatives Clearing Organizations (RIN 3038-AE87) (November 18, 2019), available at https://bettermarkets.com/sites/default/files/Better_Markets_Inc._Letter_on_Registration_with_Alternative_Compliance_for_Non-U.S._Derivatives_Clearing_Organizations_RIN_3038-AE87.pdf.

52 See 7 U.S.C. § 2(h)(1)(A) (providing that "[i]t shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a [DCO] that is registered . . . or a [DCO] that is exempt from registration . . . if the swap is required to be cleared").

Sincerely,

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