March 9, 2020

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street NW
Washington, DC 20581

RE: Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants (RIN 3038-AE84)

To Whom It May Concern:

The Americans for Financial Reform Education Fund ("AFR") appreciates the opportunity to comment on the above referenced Notice of Proposed Rule (the "Proposal" or "NPRM") concerning the Commodity Futures Trading Commission's ("CFTC" or "Commission") application of Dodd-Frank swaps registration thresholds and transaction requirements to cross-border transactions. Members of AFR Education Fund include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

Global derivatives markets played a critical role in the 2008 financial crisis. The collapse of two major internationally active derivatives dealers, Bear Stearns and Lehman Brothers, played a central part in the early phases of the crisis and then in the final liquidity freeze that led to financial market breakdown. The grant of supervisory authority over global derivatives markets to the CFTC and the Securities and Exchange Commission (SEC) was a key part of post-crisis financial market reforms enacted in the Dodd-Frank statute.

Because derivatives markets were and remain highly internationalized, the effective cross-border enforcement of this authority is critical to executing on the promise of Dodd-Frank regulation of derivatives markets. AFR has commented numerous times over the past decade on the CFTC's efforts to define the application of derivatives rules to cross-border transactions involving U.S. entities and their subsidiaries. There are some concepts and rulings advanced by the Commission that we have favored, such as the definition and use of the "Foreign Consolidated Subsidiary" concept in the 2016 margin rule. At least in the area of certain margin requirements, this concept properly recognized the ways in which risk incurred in foreign subsidiaries of U.S. banks unavoidably impacts the U.S. markets and public. However, we have also been deeply concerned that the CFTC has been excessively permissive in permitting nominally "non-guaranteed"

---

[1] A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/

foreign subsidiaries to escape the reach of important derivatives requirements, creating loopholes that allow a partial or complete end run around regulatory supervision of derivatives markets and replicating the pre-crisis situation where these markets escaped oversight.

This NPRM doubles down on the overly permissive approach seen in elements of previous proposals and leaves no doubt that the Commission has retreated from its responsibility to properly regulating cross-border derivatives involving U.S. entities. This is not because the Commission fails to grasp the significance of the issue. Indeed, this Proposal acknowledges numerous times that derivatives markets are essentially borderless and that there is no meaningful economic separation between the risks of foreign subsidiaries and the consolidated balance sheet of the U.S. parent. To take just one example, the Proposal begins with the statement that:[2]

> "a global financial enterprise effectively operates as a single business, with a highly integrated network of business lines and services conducted through various branches or affiliated legal entities that are under the control of the parent entity. Branches and affiliates in a global financial enterprise are highly interdependent, with separate entities in the group providing financial or credit support to each other, such as in the form of a guarantee or the ability to transfer risk through inter-affiliate trades or other offsetting transactions. Even in the absence of an explicit arrangement or guarantee, a parent entity may, for reputational or other reasons, choose to assume the risk incurred by its affiliates, branches, or offices located overseas. Swaps are also traded by an entity in one jurisdiction, but booked and risk managed by an affiliate in another jurisdiction. The Proposed Rule recognizes that these and similar arrangements among global financial enterprises create channels through which swap-related risks can have a direct and significant connection with activities in, or effect on, commerce of the United States."

The NPRM then goes on to assert, correctly, that the broad statutory authority in CEA Section 2(i) grants the CFTC the power to regulate all cross-border transactions that are connected to the economy of the United States – which the Proposal has just acknowledged would include derivatives transactions conducted by all the global subsidiaries of a U.S. parent.

Yet in the details and substance of the NPRM the Commission repeatedly creates loopholes and gaps in applicable regulations which permit large derivatives dealers to escape regulation of their transactions by routing them through international subsidiaries. Unlike the clear statement of authority in CEA 2(i) these loopholes are justified by vague non-statutory principles such as "international comity" and deference to the prudential standards of the Federal Reserve and foreign banking regulators.

It is particularly remarkable that the proposal would grant such sweeping deference to prudential regulators such as the Federal Reserve and foreign banking agencies, by exempting foreign bank subsidiaries subject to consolidated Federal Reserve or local prudential regulation from CFTC

[2] CFR 954-955

standards.[3] Subsidiaries of bank holding companies (BHCs) that deal in derivatives were already subject to consolidated Federal Reserve supervision prior to the 2008 financial crisis. Federal Reserve and foreign banking supervisors were obviously aware of the existence of swaps risks and attempted to apply basic safety and soundness standards to such risks. However, such supervision failed to stem the systemic risks of derivatives since derivatives markets were not subject to a consistent regime of market regulation that forced transparent and consistent pricing, trade reporting, clearing, margining, and overall responsible business conduct.[4] The failure of consolidated prudential supervision of banks to properly address derivatives market risks is the major reason that the CFTC was granted authority as a derivatives market regulator in Dodd-Frank in the first place. Yet in this proposal consolidated prudential supervision serves as an excuse for the Commission to step back from its regulatory responsibilities for central parts of the derivatives market.

This is a lengthy and complex proposal. At each stage of the proposal, attention is paid to the various ways in which cross-border transactions could create risks that affect the U.S. market. However, in each case the regulatory approach incorporates back doors and exit ramps by which internationally active derivatives dealers could evade CFTC regulation for transactions routed across borders. Given the relatively short (60 day) comment period permitted for this NPRM, combined with the tidal wave of other deregulatory proposals emerging from the Commission and other financial regulators, we anticipate further and more detailed comment in the future as we examine elements of the Proposal. But some broad deficiencies of this proposal include:

The definition of U.S. person – despite the fact that the Proposal repeatedly acknowledges that the risks of consolidated foreign subsidiaries of large U.S. entities are economically difficult or impossible to separate from their U.S. parents, the NPRM defines "U.S. person" solely by reference to domicile or organization within the U.S. This permits owned foreign subsidiaries of U.S. banks, hedge funds, or other derivatives market dealers or major participants to avoid designation as U.S. persons and in thus the full application of U.S. law. Further, the proposal would even allow branches of U.S. persons, which are actually formally and legally part of the parent U.S. organization, to effectively act as non-U.S. persons.

The definition of "guarantee" – besides being a U.S. person directly, a transaction guarantee by a U.S. person is another way in which the applicability of CFTC regulations can be triggered. However, the definition of guarantee here appears very narrow and focused on cases where a counterparty has a legally enforceable right of recourse to a U.S. person for a specific derivatives transaction or transactions. This permits numerous informal or even formal forms of guarantees between U.S. parent corporations and their subsidiaries to escape the definition. To take just one example, the Proposal states that a situation in which a U.S. person guaranteed to provide a foreign subsidiary ("Subsidiary A") with funding for all of its derivatives obligations to another

---

[3] I.e. by exempting subsidiaries of banks subject to consolidated Federal Reserve supervision from designation as "Systemic Risk Subsidiaries", the only subsidiaries subject to core CFTC regulatory standards.

[4] Duffie, Darrel, "Prone to Fail: The Pre-Crisis Financial System". Journal of Economic Perspectives, Volume 33, Number 1, Winter, 2019. Available at https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.33.1.81

foreign party ("Counterparty B") would not fall under the guarantee definition. Thus, the transactions between Subsidiary A and Counterparty B would not be counted as having a guarantee or a connection to the U.S. economy that triggers coverage under U.S. law, because Counterparty B would technically not have a legally enforceable right of recourse to a U.S. person. This seems to fly in the face of the economic logic of a guarantee.

The definition of "Significant Risk Subsidiary" (SRS) – a third way in which a cross-border transaction can trigger the application of U.S. law under the NPRM is when they are conducted by or through a SRS. The SRS category is explicitly designed in the Proposal to address situations where the derivatives operations of large foreign subsidiaries pose major risks to their U.S. parents. Yet the NPRM exempts so many different types of entities from the SRS definition that it appears that almost no foreign subsidiaries of U.S. entities would qualify. For example, all subsidiaries subject to consolidated supervision as part of a U.S. bank holding company are exempted, as are all subsidiaries subject to foreign prudential supervision. This immediately exempts all foreign subsidiaries of large U.S. global banks from the SRS definition. Consolidated prudential supervision of bank derivatives operations existed prior to the 2008 financial crisis, and cannot justify a sweeping exemption from the application of market regulation statutes passed in response to the failure of such supervision to control derivatives risks.

As if this sweeping exemption for banks is not enough, the SRS definition also exempts all subsidiaries of U.S. parents with under $50 billion in balance sheet assets, thus exempting subsidiaries almost all hedge funds and asset managers from the definition as well.

The treatment of transactions that are "arranged, negotiated, or executed" (ANE) in the U.S. – the NPRM fails to include a provision that properly applies CFTC regulations to transactions that are ANE in the United States but placed on the books of non-U.S. persons that are not formally guaranteed by a U.S. person or a SRS of a U.S. person. In this way, the Proposal permits derivatives dealers located within the U.S. to engage in transactions using U.S. personnel on U.S. soil without being subject to U.S. law, so long as they administratively treat them as booked in a foreign subsidiary.

Treatment of swap dealer registration requirements – the Proposal nominally maintains the Aggregation Requirement under the 2013 Cross-Border Guidance which requires a person to include within its de minimis calculations all swaps conducted by affiliates under common control, to the extent that such affiliates are required to count such swaps toward their own de minimis requirement, and applies this standard to all U.S. and non-U.S. persons. We agree with this approach conceptually. However, its effect is negated in this Proposal by the fact that affiliates which are not SRS would not have to count non-guaranteed swaps with other non-U.S., non-SRS persons toward their own de minimis calculations. In this way, the weakness of the other definitions in the NPRM impacts the calculation of the de minimis registration thresholds. It will be simple for large international banks and other significant actors in U.S. derivatives markets to conduct dealing through foreign subsidiaries that need not be counted toward de minimis thresholds at the subsidiary level. Aggregating the activities of affiliates is not a

meaningful protection against evasion of dealer registration requirements if those activities are themselves not counted against de minimis registration requirements.

Definition of "comparability" for substituted compliance – even if a derivatives market participant should still find itself to still be covered by a substituted compliance requirement under this rule, the weakening of the standards for comparability under this NPRM would undermine any guarantee that substituted compliance creates a truly equivalent situation to U.S. law. The NPRM's new standard would only require that "some or all" of a foreign jurisdiction's requirements are equivalent to U.S. rules, instead of requiring comprehensive equivalence. Further, such core issues as whether the foreign jurisdiction's rules achieve comparable outcomes to U.S. rules – seemingly an absolutely central consideration for substituted compliance purposes – are made *optional* matters for Commission consideration. Incredibly, Section 23.23(g)(4) of the rule explicitly states that the Commission "may" consider such factors, not that it must consider them.

Taken together, these weak definitions and standards appear to permit a situation in which U.S. derivatives market participants, including major U.S. banks, who wish to evade CFTC transaction requirements or registration as a CFTC-regulated derivatives dealer can simply conduct transactions through a foreign subsidiary. Should they wish to transact with another U.S. bank or U.S. person, they can simply have their own subsidiary transact with the foreign subsidiary of that U.S. person. Such transactions could even be arranged and executed on U.S. soil so long as they meet the administrative formality of being booked in a foreign subsidiary. Even if such transactions are subjected to substituted compliance requirements, the weakening of standards for substituted compliance in this Proposal offers no security that rules equivalent to U.S. law will govern the transaction.

In sum, this NPRM would fatally weaken the implementation of Title VII of Dodd-Frank and its application to CFTC-regulated derivatives markets. We urge the Commission to step back from course outlined in this Proposal and restore elements of the 2013 Guidance and the 2016 Margin Proposal that offered better oversight of derivatives markets.

Thank you for the opportunity to comment on the Proposal. If you have questions, please contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org

Sincerely,

Americans for Financial Reform Education Fund