SPEECHES & TESTIMONY

Dissenting Statement of Commissioner Dan M. Berkovitz regarding Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants

December 18, 2019

I dissent from today's cross-border swap regulation proposal (the "Proposal") because it would significantly weaken the Commission's existing regulatory framework that protects the United States from risky overseas swaps activity. The existing cross-border framework has worked well over the past six years to protect the U.S. financial system from risks from cross-border swaps activity, while simultaneously enabling U.S. banks to compete successfully in overseas markets.[1] The Proposal would create multiple loopholes for U.S. banks to evade the Commission's oversight of their cross-border activity and pose risks to the U.S. financial system. With a wink and a nod, U.S. banks could effectively guarantee their overseas swap dealing affiliates from losses while also enabling those affiliates to escape regulation as swap dealers. The Proposal would enable U.S. banks to book their swap trades in unregistered foreign affiliates that would not be required to report their swaps in the United States, and would not be subject to our capital, margin, and risk management requirements.

The Proposal also sends us down a rabbit hole with a complex new entity designation, "Significant Risk Subsidiary" ("SRS"). An SRS would be a type of overseas swap dealing affiliate that in theory is subject to greater Commission oversight. The Proposal admits, however, that there would be "few, if any," entities in this elusive category.[2] What is the purpose of creating a complicated category that does not include a single entity? This is a Seinfeldian regulation—a regulation about nothing.[3]

The Proposal would transform the Commission from a watchdog guarding U.S. shores into a timid turtle, reluctant to poke its head out of its domestic shell. When the next financial crisis arrives, will foreign governments bail out affiliates of U.S. persons located in their jurisdictions? Experience has taught us that while finance may be global, global financial rescues are American. With today's Proposal, I fear that the U.S. tax payer will once again be called on to bear the costs. We've been down this de-regulatory road before, and it ended in disaster for the United States and the global financial system. Congress enacted the Dodd-Frank Act to avoid these same mistakes, yet today the Commission is voting out a proposal that ignores both those lessons and the law.

Why Cross-Border Swaps Must be Regulated by the CFTC

It seems that every few years, we must remind ourselves of why regulating cross-border financial transactions, and swaps in particular, is important to managing systemic risk. If we forget, the financial system delivers its own destructive reminders. Examples from recent history prove that foreign financial activity, usually involving swaps, can lead to massive losses triggering the need for emergency action by the Department of the Treasury and/or the Federal Reserve System—sometimes at the expense of the U.S. taxpayer. As described later in my statement, the Proposal would undermine the direction in CEA section 2(i) to regulate cross-border swap activity, and again allow such activity by U.S. financial institutions to go unobserved and unsupervised.

In 1998, the U.S. hedge fund Long-Term Capital Management L.P. ("LTCM") was saved from failure through an extraordinary bailout by 15 banks. The bailout was brokered by the Federal Reserve Bank of New York. The near failure of LTCM roiled financial markets. The financial system could have seized up if LTCM had failed because of the large and opaque derivatives exposures that many U.S. banks had with LTCM.[4] Although LTCM was mostly managed from Connecticut, it was a Cayman Islands entity with over a dozen affiliates, only $4 billion in capital, and a complex derivatives book with a notional amount in excess of $1 trillion.[5]

In 2007, U.S.-based Bear Stearns provided loans intended to shore up two Cayman Islands hedge funds sponsored by Bear Stearns. Bear Stearns was not legally obligated to back the funds financially. Those actions were the beginning of a chain of events that eventually led to the fire sale of Bear Stearns to J.P. Morgan in March 2008. To entice J.P. Morgan to buy a distressed Bear Stearns, the Federal Reserve System provided financial support for the purchase.[6] This is not to suggest that Bear Stearns failed solely because of swap activity, but to illustrate how financial institutions are essentially obligated to support foreign affiliated entities even when they do not guarantee performance, and how such support can have serious consequences to the U.S. financial system.

Walter Wriston, former chairman and CEO of Citicorp, testified to Congress regarding the obligation of a parent bank to bail out a subsidiary, no matter the degree of legal separation: "It is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. *Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way*."[7]

When Lehman Brothers went bankrupt and triggered the 2008 financial crisis, its London affiliate, Lehman Brothers International Europe, had a book of nearly 130,000 swaps that took many years to resolve in bankruptcy.[8] Soon thereafter, American International Group would have failed as a result of swaps trading by the London operations of a subsidiary, AIG Financial Products, if not for over $180 billion of support from the Federal Reserve System and the U.S. Department of Treasury. [9]

In 2012, on the eve of the swap dealer regulations going into effect, J.P. Morgan Chase & Co. disclosed multi-billion dollar losses from credit-related swaps managed through its London chief investment office. While this loss did not require the Treasury or the Federal Reserve System to act, it did result in an enforcement action by the CFTC. The enforcement order detailed how the trading activity that caused the loss would have been subject to tighter controls and oversight—and likely would not have happened—if the activity had been subject to swap dealer regulation by the CFTC.[10]

Each of these very substantial financial failures occurred at least in part because of overseas activity by U.S. financial institutions. Although the activity occurred away from the United States, and was not subject to direct U.S. regulatory oversight, the risks and the costs both came back to the United States.

Foreign derivatives activity is of particular concern because derivatives are, by their very nature, contracts that can transfer large amounts of risk between entities and across borders. Congress recognized this concern when it adopted CEA section 2(i) applying the swaps provisions of the Dodd-Frank Act to regulate cross-border swaps activity that has a "direct and significant connection with activities in, or effect on, commerce of the United States." Notably, this cross-border jurisdiction is both activity-based as well as effects-based. It is the nature of the activity and its connection to commerce in the United States—not simply the level of risk presented—that is the basis for the CFTC's cross-border jurisdiction. Congress recognized that we cannot always foresee the risks presented by swap activities. By supposedly focusing on risk, the Proposal ignores this crucial insight and critical component of the Commission's cross-border jurisdiction.

But even with respect to activities presenting serious risks to the United States, the Proposal gets it wrong. The risks incurred by foreign affiliates are transferred, or otherwise inure, to the U.S. parent firms in several ways. The traditional method was for the U.S. parent to guarantee the swap payment obligations of its foreign affiliates. Swap dealers removed many of those formal, written guarantees that were executed prior to the financial crisis in 2014 after the 2013 Guidance was issued (more on that later). Alternatively, using inter-affiliate swaps, a foreign affiliate typically transfers to its U.S. parent all of the risk it incurs in a swaps portfolio. While the U.S. parent may not be directly liable to the counterparties of its foreign affiliate, any losses of the affiliate are equivalent to losses the parent incurs on its swap with the affiliate. If the affiliate makes bad bets, the parent pays for them. Finally, a U.S. parent can be less directly responsible for its foreign affiliate's swap obligations through capital contribution arrangements (e.g., keepwell agreements or deed-poll arrangements), or simply because letting an affiliate fail and default to numerous foreign entities is untenable as a business matter. As Walter Wriston noted, as a matter of market survival a U.S. bank would not allow a wholly-owned affiliate to fail and default on its swap obligations.

The Commission's regulation of cross-border swap activity should address all of these risk transfer conduits. At the same time, it should be flexible enough to allow U.S. banks to compete in global markets. In my view, the 2013 Guidance and the attendant no action relief achieved the right balance and is working well. As noted above, U.S. banks are competing throughout the world. In fact, they are out-competing their non-U.S. competitors. There is no persuasive reason to weaken a regulatory standard that is consistent with our law and that has successfully protected the American people for the last six years—*while simultaneously witnessing the global preeminence of American banks*. The Proposal snatches defeat from the jaws of victory.

The Proposal would greatly weaken the Commission's ability to monitor and regulate foreign swap activity by U.S. financial institutions, putting our financial system at risk once again. Only ten years after the financial crisis, the Proposal tosses aside hard lessons learned at the expense of 10% unemployment, millions of foreclosures, massive bailouts, and lasting damage to the economic fortunes of tens of millions of our fellow citizens. It does this in the interest of secondary considerations—harmonization, a "workable framework" for regulations, and reducing costs. Whereas "legal certainty" was the buzzword to limit the CFTC's jurisdiction over the swaps market in the 1990s and 2000s, today's de-regulatory mantra includes "harmonization," "reducing fragmentation," and "deference." Call it what you like, but the results are intended to be the same: preventing the CFTC from overseeing the swaps activity of major U.S. banks. Creating the possibility for another taxpayer-funded bailout for overseas swap activity cannot possibly be the right outcome for the American people.

What is Wrong with the Proposal

The Proposal starts on a good note by essentially adopting the interpretation of CEA section 2(i) contained in the 2013 Guidance. The Proposal also acknowledges that "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."[11] It then explains that the entities in a global financial enterprise provide "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."[12] The Proposal then uses the basic framework of the 2013 Guidance and adopts some of its substantive provisions.

But the Proposal makes a number of changes to key provisions, all geared toward limiting the application of our regulations. Most concerning are the narrowing of the definition of "guarantee" and "U.S. persons," and codifying full relief for arranging, negotiating, or executing ("ANE") swaps in the United States that are then booked in non-U.S. legal entities. Together, these provisions in the Proposal create a loophole through which U.S. financial institutions can undertake substantial swap dealing activity outside the U.S. swap regulatory regime through unregistered foreign affiliates and bring the risks they incur back to the United States. In addition, these key provisions allow U.S. persons to undertake substantial dealing activity *inside* the United States and then evade regulation by booking the trades in foreign entities. Together, these provisions will codify a framework for circumventing our swap regulations greatly undermining CEA section 2(i) and Title VII of the Dodd-Frank Act.

I am concerned that codifying this result will encourage U.S. banks to book much of their swap dealing activity in foreign affiliates that limit their swap dealing with U.S. persons and therefore will not have to register as swap dealers. Under the narrowed definition of "guarantee" in the Proposal, the U.S. parents would be able to provide full financial support to these unregistered foreign affiliates, just not in the form of an explicit, direct swap payment guarantee. Furthermore, these changes will allow two U.S. entities, whether they are, for example, two global banks or a global bank and a large U.S. corporation, insurance company or hedge fund, to trade with each other without subjecting that trade to U.S. oversight so long as the trade is booked in foreign affiliates. Finally, by largely eliminating the ANE requirement,[13] those U.S. firms can use their employees in the United States for that trading activity and still evade U.S. regulation if the swaps are booked in foreign affiliates. As discussed above and acknowledged in the Proposal, the U.S. parents will still be on the hook because the risks incurred by the foreign affiliates is transferred back to the U.S. parent through swaps with the affiliate and/or through other capital support mechanisms.

This outcome is not merely an issue of whether the foreign affiliates of U.S. persons need to register as swap dealers. By not registering, these foreign affiliates will not need to report their swap activity to CFTC registered swap data repositories. They will not be subject to our margin, capital, and risk management requirements. These firms will not be subject to the swap dealing best practices that our regulations require. CEA section 2(i) will be undermined.

The three changes in the Proposal are intended to address unintended effects on previously standard business practices that helped U.S. banks compete in global markets. A foreign counterparty that is not headquartered in the United States (a "true non-U.S. entity") may not want to trade with affiliates of U.S. banks, or with bank employees in the United States, if doing so means the true non-U.S. entity would need to count those swaps toward its CFTC swap dealer registration threshold.

Under the 2013 Guidance, guaranteed foreign affiliates of U.S. banks are deemed U.S. persons for purposes of counting dealing swaps with U.S. persons. The term "guarantee" was defined broadly. Once it became apparent that true non-U.S. entities did not want to count those swaps, U.S. banks de-guaranteed their foreign affiliate swap dealers. The 2016 cross border proposal[14] tried to adjust the guidance framework by adding back into the U.S. person definition foreign consolidated subsidiaries ("FCS") that are consolidated on the books of a U.S. parent. However, that would have the effect of exacerbating the problem for U.S. banks competing for swap business with true non-U.S. entities. The Proposal discards the FCS concept and narrows the definition of a "guarantee" to solely an explicit recourse of the counterparty to the U.S. parent for payment on the swap. The Proposal further narrows the U.S. person definition to delete full recourse subsidiaries and eliminate conduit affiliates treatment for the same reasons.

I am highly skeptical that the status quo will be maintained if the ANE no action relief and de-guaranteeing framework are codified. Large U.S. banks would have incentives to de-register some of their foreign affiliate swap dealers. They are likely to maintain only one or two foreign entities that are registered to handle business with U.S. persons operating in foreign jurisdictions who want to trade with registered swap dealers. Even if they do not de-register those swap dealers, swap activity can easily be moved to other unregistered foreign affiliates that are supported by their U.S. parents in ways other than an explicit swap payment obligation guarantee.

There is a potential alternative for addressing the concerns of true non-U.S. entities without also excluding from oversight all activity of foreign affiliates of U.S. financial institutions. The regulations potentially could provide that, with substituted compliance determinations in place for key swap regulations (e.g. margin and risk management), true non-U.S. entities can trade with foreign affiliates of U.S. entities without counting those swaps toward U.S. swap dealer registration. This could be a reasonable balance of systemic safety and competitiveness.

At the same time, foreign entities that are wholly owned by U.S. parents would still be required to count swaps with other wholly-owned foreign affiliates of other U.S. parents. In this way, U.S. financial institutions can compete for foreign swap business while preventing U.S. firms from evading swap regulation by booking swaps with each other in foreign affiliates.

I invite commenters to address this potential solution.

Seinfeldian Regulation: Significant Risk Subsidiary

The Proposal contains a new regulatory construct called the "Significant Risk Subsidiary" ("SRS"). It is a putative replacement for a broader definition of guarantee and the FCS alternative. But it appears to be an empty set. The Cost-Benefit Considerations project that "few, if any" entities would fall within its ambit. It would not accomplish anything.

The SRS is a very complicated construct, with no less than six tests for determining whether a firm would qualify for regulation as an SRS. Bizarrely, none of these tests have anything to do with the amount of the entity's swap activity. The basic threshold is that the entity be affiliated with a commercial enterprise with at least $50 billion in capital. Consider this: LTCM had $4 billion in capital and a derivatives book with a notional amount of about $1 trillion at the time it was bailed out.

Another hurdle excludes any entity regulated by U.S. or foreign banking regulators. In effect, the entities that do the vast majority of swap dealing in the world are excluded from the SRS definition. With so many hurdles for the SRS determination, it appears that the Proposal has little interest in actually contributing to the control of systemic risk exposure in the U.S. financial system. The reasoning goes, if the entity is regulated by a banking regulator that follows basic Basel capital and supervision standards, then CFTC regulation is unnecessary.[15] But Congress decided in 2010 when it adopted the Dodd-Frank Act that swap dealing needed to be separately regulated from prudential bank regulation. The catastrophic cross border financial failures discussed previously in this statement demonstrate why these additional protections are necessary. Prudential regulation alone was insufficient to prevent those failures and risks to the financial system. Those failures eventually required emergency action by the Federal Reserve System and/or the Department of the Treasury.

Substituted Compliance Shortcomings

I support the principle of international comity. The CFTC should continue to recognize the interests of other countries in regulating swap activity occurring within their borders. The 2013 Guidance has a flexible, outcomes based substituted compliance review process based on a finding that the foreign regulated entities are subject to comparable, comprehensive supervision and regulation.[16] The standard of review is effectively the same as the standard established by Congress in CEA sections 4(b)(1)(A), 5b(h), and 5h(g) for finding, respectively, foreign boards of trade, swap execution facilities, and exempt derivatives clearing organizations comparable.

The Proposal would apply a lesser standard. It would permit the Commission to issue a comparability determination if it determines that "some or all of the relevant foreign jurisdiction's standards are comparable." The condition that the regulations be "comprehensive" is dropped. Furthermore, unlike the 2013 Guidance and the CEA comparability analysis, which require the Commission to make a comparability determination or finding based on the standard, the Proposal says that the Commission can consider any factors it "determines are appropriate, which *may* include"[17] four factors listed. This arbitrary, non-standard "standard" creates too much uncertainty and flexibility. The Commission should not defer regulating U.S. bank affiliates to other regulatory jurisdictions operating under a lesser standard than the Commission has previously used in this context or currently uses in other contexts.

Conclusion

The Proposal would allow U.S. banks to evade swap regulation by booking swaps in non-U.S. affiliates. The Proposal would enable U.S. banks to arrange, negotiate, and execute swaps in New York, but avoid swap regulation by booking those swaps in their non-U.S. affiliates. A non-U.S. affiliate of a U.S. bank could enter into trillions of dollars of swaps with non-U.S. affiliates of other U.S. entities without registering with the CFTC as a swap dealer. The U.S. parent bank could provide full financial support for those non-U.S. affiliates so long as the support does not come in the narrow form of an explicit swap payments guarantee.

Ultimately, the risk from all of those swaps will still be borne by the parent bank in the United States. These risks can be very large. The activities of bank affiliates outside the United States have a direct and significant connection with activities in, or effect on, commerce in the United States. In Title VII of the Dodd-Frank Act, the Congress directed the CFTC to apply its swap regulations to these activities. Because the Proposal retreats from these responsibilities, I dissent.

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[1] U.S. banks are the strongest in the world. The Global League Tables ranking global banks by amount of banking business activity shows that three or four U.S. banks are in the top five banks in almost every category, including for banking business in foreign markets. *See* GlobalCapital.com, Global League Tables, available at https://www.globalcapital.com/data/all-league-tables. While we could not locate a global ranking of banks by swap business, GlobalCapital.com selected Bank of America Merrill Lynch as "derivatives house of the year" and four of the seven other banks shortlisted for the award were U.S. banks. *See* Ross Lancaster, *Global Derivatives Awards 2019: the winners*, GlobalCapital.com (Sept. 26, 2019), available at https://www.globalcapital.com/article/b1h9txdc91yw4k/globalcapital-global-derivatives-awards-2019-the-winners. By comparison, in 2006, "Deutsche Bank dominate[d] in every region" in the competition for derivatives house of the year. *See* Yassine Bouhara, *Global Derivatives House of the Year*, GlobalCapital.com, (Nov. 9, 2006), available at https://www.globalcapital.com/article/k64qjpc6mxwc/global-derivatives-house-of-the-year.

[2] *See* Proposal, section VII.C.2(i).

[3] *See* Wikipedia.org, *Seinfeld*, available at https://en.wikipedia.org/wiki/Seinfeld.

[4] *See* The President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (Apr. 1999) available at http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf; *see also* International Monetary Fund, *World Economic Outlook and International Capital Markets* (Dec. 1998), available at https://www.imf.org/external/pubs/ft/weo/weo1298/pdf/file3.pdf.

[5] *Id.*

[6] *See* Reuters, *Timeline: A dozen key dates in the demise of Bear Stearns* (Mar. 17, 2008), available at https://www.reuters.com/article/us-bearstearns-chronology/timeline-a-dozen-key-dates-in-the-demise-of-bear-stearns-idUSN1724031920080317.

[7] *See* https://en.wikipedia.org/wiki/Walter_Wriston (citing Financial Institutions Restructuring and Services Act of 1981, Hearings on S. 1686, S. 1703, S. 1720 and S. 1721, before the Senate Committee on Banking, Housing, and Urban Affairs, 97th Congress, 1st Session, Part 11, 589-590) (italics added).

[8] *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 FR 45292, 45294 (July 26, 2013) ("2013 Guidance").

[9] *Id.* at 45293-94.

[10] *See In re JPMorgan Chase Bank, N.A.*, CFTC No. 14-01, 2013 WL 6057042, at *6-8 (Oct. 16, 2013), available at https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfjpmorganorder101613.pdf.

[11] Proposal, section I.B. (noting that large U.S. banks have thousands of affiliated entities around the world.)

[12] *Id.* The Proposal notes that "even in the absence of an explicit arrangement or guarantee, the parent entity may, for reputational or other reasons, choose or be compelled to assume the risk incurred by its affiliates, branches, or offices located overseas."

[13] At my request, the preamble to the Proposal was modified to clarify that our anti-fraud and anti-manipulation regulations never the less apply to the conduct occurring in the United States.

[14] Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 FR 71946 (Oct. 18, 2016).

[15] "An entity that meets either of these two exceptions, in the Commission's preliminary view, would be subject to a level of regulatory oversight that is sufficiently comparable to the Dodd-Frank Act swap regime with respect to prudential oversight. . . . In such cases where entities are subject to capital standards and oversight by their home country regulators that are consistent with Basel III and subject to a CFTC Margin Determination, the Commission preliminarily believes that the potential risk that the entity might pose to the U.S. financial system would be adequately addressed through these capital and margin requirements." Proposal, at II.C.4.

[16] "[T]he Commission will rely upon an outcomes-based approach to determine whether these requirements achieve the same regulatory objectives of the Dodd-Frank Act. An outcomes-based approach in this context means that the Commission is likely to review the requirements of a foreign jurisdiction for rules that are comparable to and as comprehensive as the requirements of the Dodd-Frank Act, but it will not require that the foreign jurisdiction have identical requirements to those established under the Dodd-Frank Act." 2013 Guidance, 78 FR 45292, 45342-3.

[17] Proposal, rule text section 23.23(g)(4).