SPEECHES & TESTIMONY

Supporting Statement of Commissioner Brian Quintenz Regarding Proposed Rule: Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to SDs and MSPs

December 18, 2019

I am very pleased to support today's proposed rule, which, in my view, delineates important boundaries of the Commission's regulation of swaps activity conducted abroad, which would codify elements of the Commission's 2013 interpretive guidance,[1] and make important adjustments with the benefit of six years' additional experience in swaps market oversight.

Direct AND Significant

As I have said before, the foundational principle underlying any CFTC regulation of cross-border swaps activity, and the prism through which all extraterritorial reach by the CFTC must be viewed, is the statutory directive from Congress that the agency may only regulate those activities outside the United States that "have a direct and significant connection with activities in, or effect on commerce of, the United States." [2] Congress deliberately placed a clear and strong limitation on the CFTC's extraterritorial reach, recognizing the need for international comity and deference in a global swaps market.

I believe the proposal strikes a strong balance in interpreting Section 2(i) of the CEA. The proposal before us would interpret this provision in ways that both provide important safeguards to the U.S. financial markets, and avoid duplicative regulation or disadvantaging U.S. commercial and financial institutions acting in foreign markets.

Registration

The proposal would require a foreign institution dealing in swaps to count the notional value of the swaps it executes towards the CFTC's recently finalized $8 billion registration threshold[3] only in certain, enumerated circumstances that clearly concern U.S. institutions and implicate risk to the U.S. financial system when that risk is not otherwise addressed by the Commission or by the banking regulators.[4] I would like to highlight a few of these circumstances.

First, a foreign swap dealing firm would generally be required to count swaps executed opposite a "*U.S. person*."[5] I believe the proposed definition of *U.S. person*[6] is an improvement upon the one included in the 2013 guidance.[7] The proposed definition of *U.S. person* is also consistent with the one published by the SEC in connection with that agency's oversight over security-based SDs and MSPs.[8] Only in Washington could two financial regulators have different definitions of a *U.S. Person*. Such a harmonized definition, if finalized, will facilitate compliance with the CFTC's and SEC's swaps regulations by dually registered entities. The proposed definition is largely similar to the definition of *U.S. person* issued by the Commission in 2016 in connection with the rule for cross-border applicability of the margin requirements for uncleared swaps,[9] and more streamlined than the one included with the Commission's 2013 cross-border guidance, for example in the context of investment funds. This will make it easier for market participants readily to determine their status. One element of the definition that I would like to highlight, an element that is consistent with the SEC's rule, is that an investment fund would be considered a *U.S. person* if the fund's primary manager is located in the U.S.[10]

In addition to counting swaps opposite a *U.S. person*, a foreign firm would also be required to count swaps executed opposite a non-U.S. entity, if that firm's obligations under the swap are "*guaranteed*" by a *U.S. person*, or if the counterparty's obligations are U.S.- *guaranteed*.[11] Here too, the proposal provides a simpler, more targeted definition of *guarantee*[12] than the one published in the 2013 guidance,[13] and the definition is consistent with the one included in the Commission's cross-border rule for uncleared swap margining.[14] The definition would include an arrangement under which a party to a swap has rights of recourse against a guarantor, including traditional guarantees of payment or performance, but it would not include other financial arrangements or structures such as "keepwells and liquidity puts" or master trust agreements.

Notably, if a non-U.S. firm's obligations to a swap are *guaranteed* by a non-financial U.S. entity (meaning a U.S. commercial end-user), then that swap would be excluded from the foreign dealer's tally towards possible CFTC registration.[15] Commercial end-users typically enter into swaps for hedging purposes, and their swaps generally pose less risk to the financial system than swaps by financial institutions. The fact that a foreign dealer would not be required to count a swap with a U.S.-*guaranteed* commercial end-user towards the dealer's possible CFTC registration may give foreign subsidiaries of U.S. commercial firms a greater choice of swap dealers. This flexibility is consistent with Congress' decision not to apply to commercial end-users either the requirement that certain swaps be cleared at a derivatives clearing organization (DCO) ("*swap clearing requirement*") or that uncleared swaps be subject to margin requirements.[16]

I would also like to highlight that the proposal properly does not require a foreign dealer to count towards the CFTC's registration threshold a swap opposite a foreign branch of a U.S. institution already registered with the CFTC as an SD.[17] While a U.S. SD of course stands behind a swap executed by its foreign branch, I believe it makes sense for the Commission not to require a foreign dealer to count that swap towards the foreign dealer's tally for possible CFTC registration because the CFTC is already overseeing the U.S. firm, and its swaps, due to the U.S. firm's SD registration.

FCS – Not "Significant" on Accounting Consolidation Alone

Today's proposal makes an important, and appropriate, distinction from the Commission's 2016 proposal on the cross-border application of the SD registration threshold and SD business conduct standards.[18] That proposal would have required thousands of non-U.S. firms to count all of their dealing swaps, with U.S. and non-U.S. counterparties alike, towards possible CFTC SD registration. For instance, the 2016 proposed rule would have required every foreign subsidiary of a U.S. firm that, for accounting purposes, consolidates its financial statements into its parent, (referred to as a "*foreign consolidated subsidiary*") to count all of its swaps.[19] While an accounting link between a foreign subsidiary and its U.S. parent may have satisfied the "direct" connection to U.S. activities under CEA 2(i), an accounting link alone is meaningless in terms of the 2(i) "significant" connection to commerce of the U.S.

By contrast, today's proposal creates a sensible "significance" test for a foreign subsidiary of a U.S. firm through the classification of a "*significant risk subsidiary*," which would be required to count every dealing swap towards possible CFTC SD registration.[20] The proposed *significant risk subsidiary* class targets only a foreign entity that may present major risk to a large U.S. institution and appropriately scopes out the limits of Section 2(i) of the CEA.[21] Moreover, a *significant risk subsidiary* does not include an entity already subject to supervision either by the Federal Reserve Board or by a foreign banking regulator operating under Basel standards in a jurisdiction that the Commission determined has instituted a margining regime for uncleared swaps that is comparable to the Commission's framework for margining uncleared swaps.[22] This construct makes sense. The Federal Reserve already reviews swaps activity by foreign subsidiaries of bank holding companies.[23] Additionally, the CFTC has already found multiple jurisdictions' uncleared margin regimes comparable to ours. In order to eliminate duplicative regulation, and for the sake of international comity and respect for foreign jurisdictions' sovereignty, it is prudent for the Commission to rely on other authorities, either the Federal Reserve or its counterparts in comparable jurisdictions, to supervise the swaps entered into by non-U.S. subsidiaries of the banks they supervise on a consolidated basis.

By limiting the number of foreign firms registered with the CFTC as SDs, I believe the Commission, together with the National Futures Association (NFA), will best apply the agency's limited resources to the non-U.S. entities outside of the Federal Reserve's purview, especially given that there are already over 100 registered SDs organized in more than 10 countries.[24]

Business Conduct Requirements

In addition to setting boundaries in the area of non-U.S. firms counting swaps towards possible CFTC registration, today's proposal would build on the 2013 guidance by providing certainty regarding when a non-U.S. firm, which is registered with the CFTC as an SD, must comply with the Commission's SD standards. Again, importantly and appropriately out of respect for foreign jurisdictions, the proposal would exempt swaps executed with certain counterparties located abroad and make available compliance with local rules that the CFTC has determined comparable to its own ("substituted compliance").[25] The proposed rule also sets forth exemptions and substituted compliance for foreign branches of U.S. financial institutions registered as SDs with the CFTC.[26] As in 2013, the Commission believes that certain of the Commission's SD rules, or comparable foreign rules, should apply to every registered SD, including one organized in a foreign jurisdiction, with respect to all of the dealer's swaps, namely requirements concerning: a *Chief Compliance Officer*; a *risk management program*, including *special rules for when the SD is a member of a DCO*; *addressing conflicts of interest* and *antitrust considerations*; *recordkeeping*; *disclosing information to the CFTC and banking regulators*; and *position limits monitoring* (collectively, the "Group A requirements").[27] I note that substituted compliance is currently available for particular Group A requirements for SDs established in, and operating out of, Australia, Canada, the E.U., Hong Kong, Japan, and Switzerland.[28]

With regard to other SD requirements, namely *daily trading records*, *confirmations*, *documentation*, and *portfolio reconciliation and compression* (collectively, the "Group B requirements"),[29] today's proposal reasonably exempts foreign firms registered with the Commission as SDs, as well as foreign branches of U.S. registered as SDs, from these requirements for swaps with certain counterparties located outside of the U.S., including those non-U.S. counterparties whose swap obligations are not *guaranteed* by a *U.S. person* and those foreign counterparties not covered by the proposed definition of *significant risk subsidiary*.[30] As with the 2013 guidance, substituted compliance is also available.[31] Finally, under today's proposal, both a non-U.S. firm registered with the Commission as an SD, and the foreign branch of a U.S. firm registered as an SD, would only be required to comply with a set of business conduct requirements, those addressing how registered SDs transact with certain counterparties (collectively, the "Group C requirements"),[32] for swaps with U.S. counterparties, but not with non-U.S. counterparties.[33]

"ANE" - Eliminating the "Elevator Test"

Today's proposal makes an important distinction from how the Commission's Division of Swap Dealer and Intermediary Oversight (DSIO) addressed compliance with "transaction-level requirements" (referred to in today's proposal as Groups B and C requirements) in 2013. A November 2013 DSIO Advisory[34] suggested that a foreign CFTC-registered SD must comply with CFTC transaction-level requirements even in connection with a swap opposite another non-U.S. person if the SD used personnel located in the U.S. to "*arrange," "negotiate"* or *"execute"* (ANE) the swap. Such a broad, vague, and burdensome application caused such widespread confusion and international condemnation that it was, within 13 days of publishing, placed under no-action relief.[35] That no-action relief exists to this day, having been renewed six times.[36]

Prudently, today's proposal eliminates the ANE standard. I believe the Commission should only consider applying its transaction-level requirements to a foreign registered SD when a swap is executed opposite a U.S. counterparty.[37] The fact that the foreign SD may be using U.S. personnel to support the transaction does not implicate how the swap should be executed with a foreign counterparty. Under the limited extra-territorial jurisdiction Congress gave to the CFTC in overseeing the swaps market, it is appropriate that the Commission refrains from requiring foreign firms to comply with the CFTC's SD transaction-level requirements, or comparable foreign requirements, for swaps where both counterparties are outside of the United States and there is no U.S. nexus.

Enhancing Substituted Compliance

I am pleased that today's proposal codifies a process under which the Commission will issue future substituted compliance determinations.[38] Substituted compliance is the lynchpin of a global swaps market. Said differently, the absence of regulatory deference has been the fracturing sound we hear as the global swaps market fragments. The 11 substituted compliance determinations the Commission has issued to date for registered SDs, concerning business conduct and uncleared swap margining rules, highlight the progress other jurisdictions have made in issuing swaps rules. While not identical, those rulesets largely address the same topics and guard against the same risks. I hope that the Commission will soon be in a position to issue additional comparability determinations, particularly for Group B requirements. Whereas Group A substituted compliance determinations have been issued for six jurisdictions (Australia, Canada, the E.U., Hong Kong, Japan, and Switzerland), Group B substituted compliance determinations have been issued for only two jurisdictions (the E.U. and Japan).

In conclusion, I am pleased that the Commission is making meaningful progress in providing legal certainty to the market with regard to complying with the Dodd-Frank swaps regulations on a cross-border basis. I hope that the Commission will soon propose other cross-border regulations regarding other areas of the CFTC's swap regulations, including the swap clearing requirement, the trade execution requirement,[39] and the swaps reporting requirement.[40]

I would like to thank the staff of DSIO for their efforts on this proposal, as well as a personal thank you to Matt Daigler from the Chairman's office, who worked tirelessly on this proposal and its unpublished predecessor and has held countless conversations with me and my staff on this issue over the past year.

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[1] Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013).

[2] Sec. 2(i) of the Commodity Exchange Act (CEA).

[3] CFTC regulation 1.3 (definition of *swap dealer*, paragraph (4)), promulgated by De Minimis Exception to the SD Definition, 83 Fed. Reg. 56,666 (Nov. 13, 2018) (final rule)

[4] Proposed CFTC regulation 23.23(b).

[5] Proposed 23.23(b)(1).

[6] Proposed 23.23(a)(22).

[7] Interpretive Guidance, 45,316-317.

[8] Securities and Exchange Act rule 3a71-3(a)(3)(ii) & (4)(iv), promulgated by Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. 47,278, 47,313 (Aug. 12, 2014).

[9] CFTC regulation 23.160(a)(10), promulgated by Margin Requirements for Uncleared Swaps for SDs and MSPs – Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 34,818 (May 31, 2016).

[10] Proposed 23.23(a)(22)(ii).

[11] Proposed 23.23(b)(2)(ii) and (iii).

[12] Proposed 23.23(a)(8).

[13] Interpretive Guidance, 45,318-20.

[14] 23.160(a)(2).

[15] Proposed 23.23(b)(2)(iii)(*2*)

[16] Secs. 2(h)(1) and 4s(e) of the CEA, implemented by parts 50 and 23 subpart E of the Commission's regulations.

[17] Proposed 23.23(b)(2)(i).

[18] Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to SDs and MSPs, 81 Fed. Reg. 71,946 (Oct. 18, 2016) (proposed rule).

[19] 2016 proposed regulations 1.3(ggg)(7) and 1.3(aaaaa)

[20] Proposed 23.23(a)(12) and 23.23(b)(1).

[21] In order to be a *significant risk subsidiary*, the U.S. parent must have at least $50 billion in global consolidated assets, and the subsidiary must exceed one of three thresholds (measured according to a percentage of capital, revenue, or assets) as compared to its parent (proposed 23.23(a)(12)-(13)). The proposed definition of "*significant subsidiary"* is consistent with the definition of this term included in SEC Regulation S-X (17 CFR 210.1-01(w)).

[22] Proposed 23.23(a)(12)(i)-(ii). To date, the Commission has determined Australia, the E.U., and Japan to have issued margining regimes for uncleared swaps comparable to the Commission's (82 Fed. Reg. 48,394 (Oct. 18, 2017 (E.U.); 84 Fed. Reg. 12,908 (Apr. 3, 2019) (Australia); and 84 Fed. Reg. 12,074 (Apr. 1, 2019) (Japan)).

[23] Federal Reserve Board, Bank Holding Co. Supervision Manual, sec. 2100.0.1 Foreign Operations of U.S. Banking Organizations, available at, https://www.federalreserve.gov/publications/files/bhc.pdf.

[24] List of SDs available on the CFTC's website at, https://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.html

[25] Proposed 23.23(e)-(f).

[26] Id.

[27] CFTC regulations 3.3, 23.201, 23.203, 23.600-607, and 23.609 (referred to by the Proposal as the "Group A requirements" (proposed 23.23(a)(5) and 23.23(e)-(f)). "Entity-level" comparability determinations, available at, https://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm

[28] "Entity-level" comparability determinations, available at, https://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm

[29] CFTC regulations 23.202 and 501-504 (referred to by the Proposal as the "Group B requirements (proposed 23.23(a)(6)).

[30] Proposed 23.23(e)(2).

[31] Proposed 23.23(f)(2). Currently, substituted compliance for certain Group B requirements is available for SDs organized in the E.U. and in Japan. These comparability determinations are available at, https://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm

[32] CFTC regulations 23.400-451 (referred to by the proposal as the Group C requirements (proposed 23.23.(a)(7)).

[33] Proposed 23.23(e)(1)(ii).

[34] CFTC Staff Advisory 13-69 (Nov. 14, 2013).

[35] CFTC Letter 13-71 (Nov. 26, 2013).

[36] CFTC Letters 14-01, 14-74, 14-140, 15-48, 16-64, and 17-36.

[37] I note that the proposal also appropriately applies the Group B requirements to a swap involving a non-U.S. person that is either U.S.-*guaranteed* or a *significant risk subsidiary* (proposed 23.23.(e)(2)).

[38] Proposed 23.23(f).

[39] Sec. 2(h)(8) of the CEA, implemented by CFTC part 37.

[40] Secs. 2(a)(13) and 21 of the CEA, implemented by CFTC parts 43 and 45.