Statement on Adoption of and Changes to Security-Based Swap Rules

Commissioner Allison Herren Lee

Dec. 18, 2019

Today represents a milestone in the Commission fulfilling its responsibilities under Dodd Frank. With the adoption of today's cross-border rules and guidance, our security-based swap regulatory framework begins to take effect. The clock begins running on the requirement for security-based swap dealers to register with the Commission. I want to congratulate the staff and the Chairman for finally getting us to this point.[1] It is long overdue.

I will start by addressing briefly the Risk Mitigation Rules, which I am happy to support. These final rules adopt common sense risk mitigation techniques for some of the significant operational and counterparty risks that arise in the course of trading activity.

We learned in the financial crisis that the complex and opaque nature of certain derivatives and trading relationships can make it difficult to identify and contain significant risks before they spread beyond the relevant counterparties.[2] Disagreements over the value of derivatives positions can complicate risk management and the ability of regulators to quickly identify areas of risk in the market. Today's measures will help ensure that the largest participants in the security-based swap market will identify and address issues like valuation and other material elements of their trading relationships on an on-going basis, rather than only in times of crisis or disruption.

The rules will bring renewed attention to the need for the largest market participants to mitigate the risks that their trading activity presents—both to themselves and the broader market. I'm happy to support the recommendation.

Unfortunately, I cannot say the same for the cross-border package. The changes in that release significantly undercut the very Title VII framework they place into effect.

Bringing oversight to this market has been no small task. Many of the current business structures and practices for security-based swap dealers developed during the period prior to 2008 when derivatives were largely unregulated—both domestically and globally.[3] The theory at the time was that the sophisticated players active in these markets transacted only with other sophisticated players, and many policymakers believed that they could adequately manage the relevant counterparty credit risks.[4]

They could not. Derivatives such as credit default swaps and synthetic CDOs greatly magnified the losses caused by the collapse of the housing market. Those devastating losses started on Wall Street causing global credit markets to seize up, which then delivered that devastation directly to Main Street. People lost their homes, their jobs, and their futures. The Title VII regime under Dodd-Frank was

intended to prevent this from happening again and to bring derivatives markets under more meaningful regulation.[5]

These markets are global and interconnected, and our regulation must account for this. As the Commission noted in 2016, the large volume of cross border activity in security-based swaps presents serious risks not only to those involved in the transactions, but also to U.S. markets more broadly.[6] Unfortunately, today we dial back the cross-border regulations we adopted in 2016 before they even take effect.

The 2016 rule addressed, among other things, when a foreign entity conducting security-based swap dealing activity in the United States must register with the Commission as a security-based swap dealer. After two proposed rules[7] and extensive public comment, the Commission adopted the 2016 rule on a unanimous, bipartisan basis. One Commissioner called it, "[A] great example of consensus based rulemaking."[8]

Specifically, the 2016 rules established limits on the amount of security-based swap dealing activity in which a foreign entity could engage using U.S. employees without first registering with the Commission. Under the rules adopted in 2016, the consensus was $8 billion for credit default swaps and $400 million for other security-based swaps.[9] Under today's final rules, the majority opts instead to allow foreign entities to engage in almost unlimited security-based swap dealing activity using U.S. personnel.[10] Why does this matter? Because, as we noted in 2016, the consequences of problems that may arise can easily flow straight back to U.S. markets and investors. U.S. firms will be loath to permit the reputational harm that could arise from problems at an affiliate and will likely step in to support a foreign affiliate that gets into financial trouble.

At the time of initial adoption in 2016, the Commission considered and explained its decisions on many of the very issues touched on by today's final rules and guidance.[11] And yet, the Commission has determined to reverse those decisions before we have evidence or market experience of any kind to evaluate their effect.

The argument for this is that if this advance relief is not provided, dealers might need to restructure their operations or move certain operations outside of the United States.[12] On the record before us, this is conjecture. More importantly, we have already implemented a substituted compliance framework that could alleviate any such issues.[13] This framework would allow foreign security-based swap dealers to comply with Commission requirements by demonstrating compliance with the rules of their local jurisdiction.

Finally, and very importantly, I cannot understand why we would further weaken the bad actor disqualification under Rule 194. We have already tied our own hands in this area by—unlike other disqualifications under the securities laws—deeming businesses that violate the law automatically exempt from our bar. Now we propose to weaken the provisions against individuals.[14] Bad actor provisions provide an eminently sensible approach to protecting markets given what we know about the damage that recidivists do. These provisions protect businesses and people who play by the rules from those who do not. They are a powerful tool for achieving compliance with the law that should be used with care and precision on a case-by-case basis, not constrained and blunted in advance of misconduct.

Today's rule takes a broad approach in rolling back a number of the requirements and protections applicable to security-based swap dealers. In doing so, it both undermines and complicates the Commission's oversight of security-based swap dealing activity occurring within our borders.

I cannot support adopting today's cross-border package.

---

[1] I also want to express my gratitude to the following members of the staff for their work on these rules: *Division of Trading and Markets:* Director Brett Redfearn, Lizzie Baird, Mark Wolfe, Carol McGee, Andrew Bernstein, Laura Compton, Katia Imus, Pamela Carmody, Emily Westerberg Russell, Joanne Rutkowski, Devin Ryan, Bonnie Gauch, Joseph Levinson, Edward Schellhorn, Michael Gaw, Justin Pica, and Ajay Sutaria; *Division of Economic and Risk Analysis:* Director S.P. Kothari, Chyhe Becker, Narahari Phatak, Lauren Moore, Y.C. Loon, Burt Porter, Diana Knyazeva, Sai Rao, and Anne Yang; *Office of Compliance Inspections and Examinations:* Director Peter Driscoll, Dan Kahl, Jennifer McCarthy, Christine Sibille, and Carrie O'Brien; *Office of the General Counsel:* General Counsel Bob Stebbins, Meridith Mitchell, Lori Price, Robert Teply, William Miller, Donna Chambers, and Maureen Johansen; *Office of International Affairs:* Director Raquel Fox, Katherine Martin, Jonathan Balcom, Kathleen Hutchinson, Natasha Kaden, and Stephen Benham; and *Office of the Chief Accountant*: Giles Cohen.

[2] *See generally*, Nat'l Comm'n on the Causes of the Fin. and Econ. Crisis in the U.S., *The Financial Crisis Inquiry Report*, at 386 (2011) ("Financial Crisis Inquiry Report") ("The scale and nature of the over-the-counter (OTC) derivatives market created significant systemic risk throughout the financial system and helped fuel the panic in the fall of 2008: millions of contracts in this opaque and deregulated market created interconnections among a vast web of financial institutions through counterparty credit risk, thus exposing the system to a contagion of spreading losses and defaults. Enormous positions concentrated in the hands of systemically significant institutions that were major OTC derivatives dealers added to uncertainty in the market. The 'bank runs' on these institutions included runs on their derivatives operations through novations, collateral demands, and refusals to act as counterparties.").

[3] *See generally, id* at 47-49*. See also,* Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity that are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, Final Rule, Rel. No. 34-77104 at 17-29 (Feb. 10, 2016) ("2016 Adopting Release").

[4] *See, e.g.*, President's Working Group on Financial Markets, Report on Over-the-Counter Derivatives Markets, at 15-16 (Nov. 1999). *See also,* Financial Crisis Inquiry Report at 44-45 ("[A]s [certain] financial instruments became increasingly complex, regulators increasingly relied on the banks to police their own risks."). Former Fed Chairman Paul Volcker stated, "It was all tied up in the hubris of financial engineers, but the greater hubris [was to] let markets take care of themselves." *Id.* at 45.

[5] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, Title VII (2010). *See also*, H.R. Rep. No. 111-517 at 868-869 (2010).

[6] *See, e.g.*, 2016 Adopting Release at 65-66 ("Finally, as we have noted, a significant proportion of the dealing activity that is likely to be captured by this rule is actually carried out by foreign affiliates of U.S. financial groups. Given the significant volumes arising from the U.S. dealing activity of such foreign affiliates and the potential reputational effect that an affiliate's failure can have on other affiliates in the same corporate group, this activity may pose a risk of contagion to the U.S. financial markets . . . The final rule ensures that these affiliates, to the extent that they are engaged in such activity at levels above the relevant dealer de minimis threshold, are in fact required to register and comply with these requirements, which should mitigate [these] risks[.]").

[7] *See* Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity that are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent, Proposed Rule; Proposed Rule Amendments, Rel. No. 34-74834 (Apr. 29, 2015); Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, Proposed Rule; Proposed Interpretations, Rel. No. 34-69490 (May 1, 2013).

[8] *See* Commissioner Michael S. Piwowar, Statement at Open Meeting on Final Rules Regarding Application of Title VII Dealer De Minimis Requirements to Security-Based Swap Dealing Activity in the

United States (Feb. 10, 2016).

[9] *See* 17 C.F.R. § 240.3a71-2.

[10] The final rule allows foreign entities to avoid registering as security-based swap dealers subject to certain conditions. It does this through two primary mechanisms. First, today's Commission guidance provides that "market color" is outside the definition of "arrange, negotiate, and execute" as those terms are used in the Commission's 2016 final rules. However, the criteria used to describe the activities that constitute "market color" overlap with those that constitute arranging and negotiating transactions. The proposed guidance on market color will create unnecessary confusion and will be difficult to police and enforce. Second, the Commission is creating an exception for certain transactions from counting toward the requirement to register as a security-based swap dealer with the Commission. This exception is subject to a $50 billion notional cap for activity between two dealers, far in excess of the current $8 billion de minimis for credit default swaps or $400 million for security-based swaps that are not credit default swaps. There is no cap contained in the exemption for dealing activity between a dealer and a non-dealer.

[11] *See, e.g.*, 2016 Adopting Release at 83-87 ("We have considered commenters' concerns about the potential costs associated with the final rule, including the systems and monitoring costs, as well as the likelihood of market fragmentation arising from the full or partial exit of some dealing firms from the U.S. market. As discussed above, however, we believe that imposing the counting requirements on non-U.S. person dealers engaged in such transactions will advance important regulatory objectives."). *See also id.* at 116-125 (discussing the effects of the rule amendments on efficiency, competition, and capital formation).

[12] *See, e.g.,* Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, Final Rules; Guidance, Rel. No. 34-[Forthcoming] at 9-10 (Dec. 18, 2019).

[13] *See,* 17 C.F.R. § 240.3a71-6. *See also*, 2016 Adopting Release at 122-123 ("To the extent that these requirements achieve comparable regulatory outcomes, we note that we have proposed rules for a substituted compliance mechanism, which should mitigate this source of competitive disparity to the extent that we make substituted compliance determinations and the other prerequisites to substituted compliance have been satisfied.").

[14] There are two ways today's rule change weakens individual disqualification. First, because the new de minimis exemption will allow some foreign dealers arranging, negotiating, or executing trades using U.S. personnel to avoid registration, the SEC's statutory disqualification provisions will not apply to employees of those foreign entities that otherwise would apply. Second, today's rule creates a new exclusion that would allow an employee of an SEC-registered foreign security-based swap dealer who has committed fraud to participate in buying, selling, trading, or effectuating security-based swap transactions if the employee:

1. Is not a U.S. person;
2. Is not involved in buying, selling, trading, or effectuating security-based swap transaction with a U.S. person; and
3. The employee is not subject to statutory disqualification through an order from the Commission, the Commodity Futures Trading Commission, or a financial regulator in the jurisdiction where the person is currently employed or located.