SPEECHES & TESTIMONY

Statement of Commissioner Dawn D. Stump Regarding Proposed Rule: Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants

December 18, 2019

Overview

As I have previously observed from this dais, when the G-20 leaders met in Pittsburgh in the midst of the financial crisis in 2009, they correctly recognized that the derivatives markets are global and that designing a workable solution, though complicated, demands coordinated policies and cooperation.[1] To do otherwise would ignore the reality that modern markets are not bound by jurisdictional borders. Yet, while each country agreed to this coordinated approach, our pace of implementation differed.

It has been over six years since the CFTC adopted its Cross-Border Interpretive Guidance and Policy Statement ("Guidance").[2] So much has changed since then. We have now implemented nearly the entire swap regulatory regime called for by the Dodd-Frank Act[3]; equally important, many of our fellow regulators have implemented commensurate reforms, thus aligning our regulatory principles, just as the G-20 envisioned. Our deference to the comprehensive swaps regulation of our international colleagues is demonstrated by the fact that since the Guidance was issued, the CFTC has issued 11 comparability determinations regarding the regulation of swap dealers in the European Union, Canada, Japan, Australia, Hong Kong, and Switzerland.

I have long believed that our cross-border Guidance would ultimately prove temporary, and that we would need to update it to reflect current realities. I also am not surprised that we are undertaking this re-examination of our cross-border approach to swap dealer regulation through a rulemaking. After all, given the nascent state of post-Pittsburgh derivatives reforms in 2013, the Guidance was just that – guidance. It is not binding on the CFTC or swap market participants.[4]

Based on our experience during the intervening years, we are now able to replace the Guidance with actual regulations. This is a substantial step forward in the agency's implementation of the Dodd-Frank requirements. We are today proposing rules of the road that, if adopted as final, would impose binding obligations with respect to the cross-border activities of swap dealers and major swap participants ("MSPs"). And if those rules were violated, we could, and we would, bring enforcement action as a result.

Because they will be binding and enforceable, though, our cross-border rules – like all our rules – must be clear, they must be sensible, and they must be workable. I believe that the proposed rules before us today meet those standards. I therefore support them, and I look forward, as always, to receiving the valuable input of market participants and members of the public on ways in which they can be further improved.

Taking Stock

In a moment, I will talk about how a couple of the proposed rules in particular meet the clear, sensible, and workable standard. But first, it is important to level-set.

There currently are about 107 registered swap dealers, approximately 60% of which (64) are located outside the United States.[5] These numbers have stayed relatively constant since the CFTC's swap dealer registration regime "went live" at the end of 2012. Those 64 foreign swap dealers are located across the globe – in North and South America, Europe, Asia, and Australia. In other words, although it is non-binding, the CFTC's Guidance appears to have brought a substantial portion of global swap dealing activity into the CFTC's swap dealer regulatory regime.

Our intent in issuing these proposed rules – or certainly my intent – is not to sweep an even greater portion of global swap dealing activity within our jurisdiction, nor is it to enable a significant number of currently registered swap dealers to withdraw from registration. Rather, the intent is to codify the Guidance into our rule set, with a few improvements.

It is somewhat ironic that I would today be supporting a codification of the Guidance. When the CFTC was considering the Guidance, I shared the view vividly articulated by then-Commissioner Jill Sommers that the Guidance, as it had been proposed, reflected "what could only be called the 'Intergalactic Commerce Clause' of the United States Constitution . . ."[6] Had I been a Commissioner at the time the final Guidance was issued, I likely would have voted against it.

But the question before us today is not whether the Guidance was the right thing to do at the time, but what is the right thing to do now. As I have noted, regulators in the world's major financial centers have adopted comprehensive and comparable regulatory regimes governing the conduct of swap dealers, for which the CFTC has permitted substituted compliance in many instances. And market participants (both those that have registered and those that have had to determine whether they are required to register) have devoted a tremendous amount of human and financial resources to navigating the complicated contours of the Guidance. Accordingly, in the absence of any evidence that the Guidance is seriously over- or under-inclusive, our role today should be to update and improve the Guidance as we codify it, and not to propose substantially different cross-border provisions that we might wish had been adopted back in 2013.

Section 2(i)

In that regard, let me say a few words about Section 2(i) of the Commodity Exchange Act ("CEA"). Section 2(i) limits the international reach of CFTC swap regulations by affirmatively stating that they "shall not apply to activities outside the United States unless those activities . . . have a direct and significant connection with activities in, or effect on, commerce of the United States."[7] A common sense reading of this section, aptly titled "Applicability" in the CEA, is that there is a limited extraterritorial reach to the Dodd-Frank swap requirements, and to stretch them beyond the stated statutory criteria impermissibly infringes upon the rule sets of other nations.

That is, the plainly stated congressional intent is to start with U.S. law not applying beyond our borders, and then continue to the limited conditions where extraterritoriality would be deemed appropriate. The law does not say that CFTC rules govern derivatives market activities around the world if there is **any** linkage or tie to the United States and should not be interpreted and abused as such.

The proposed rulemaking before us today, because it essentially codifies the Guidance, also reiterates the interpretation of Section 2(i) that was included in the Guidance. And because I support the proposal for the reasons I have stated, I accept that interpretation in this limited context. To codify the Guidance while revising the foundation on which it was based would only generate confusion – as opposed to the clarity that, as I have indicated, I hope this rulemaking will bring to one aspect of our cross-border work.

But as we proceed with other aspects of that cross-border work – in areas such as clearing, reporting, and trade execution – I will not view the Section 2(i) interpretation we propose today as a precedent that mandates a particular result.[8] I agree that Section 2(i) does not require an analysis of every swap transaction to evaluate whether it meets the "direct and significant" test to warrant extraterritorial treatment. But rigorous analysis of the Section 2(i) test for each rule we adopt is necessary to ensure that the law is followed both to the letter and in spirit.

Clear, Sensible, and Workable Rules

I would now like to briefly highlight two areas in which the proposed rules are more clear, sensible, and workable than the provisions in the Guidance: 1) first, the definition of a "U.S. person;" and 2) second, the concept of a significant risk subsidiary.

Definition of a "U.S. Person"

One aspect of the definition of a "U.S. person" in the Guidance that we are codifying today includes legal entities that are organized or incorporated, or have their principal place of business, in the United States. That is appropriate. But the Guidance also included a separate, ill-defined, group of legal entities majority-owned by U.S. persons in which such persons bear "unlimited responsibility for the obligations and liabilities of the legal entity."

This additional category of legal entities does not appear to have come from any other U.S. statute or regulatory regime, and it is not at all clear what type of legal entities it encompasses. Ironically, the only two examples in the Guidance of entities that would fall within this prong of the "U.S. person" definition are certain types of entities formed under the laws of the United Kingdom and various Canadian provinces.[9] The proposed rules provide needed clarity and certainty to the U.S. person definition by omitting this prong of the Guidance definition.

While some aspects of the U.S. person definition in the Guidance were unclear, as just discussed, others were unworkable. The Guidance stated that the Commission "will interpret the term 'U.S. person' generally to include, but not be limited to" the categories of individuals and entities that it identified. When the entire construct for determining whether an entity must register as a swap dealer hinges on knowing whether the entity or its counterparty is a U.S. person or bears some specified relationship to a U.S. person, the definition of a U.S. person simply cannot be left open-ended.

In order to provide certainty and a workable cross-border regime for the registration and regulation of swap dealers, the proposed rules omit this language of non-exclusivity that was included in the Guidance. If the Commission subsequently determines that the categories of individuals and entities identified in the proposed U.S. person definition somehow miss a group that should be included, it can amend the definition accordingly.

Significant Risk Subsidiaries

Before getting to the concept of a significant risk subsidiary ("SRS") in the proposed rules, let me first mention its predecessor from the Guidance: the "affiliate conduit." The Guidance did not actually define an affiliate conduit; rather, it merely presented "certain factors [that] are relevant to considering whether a non-U.S. person is an 'affiliate conduit.'"

In most cases, the critical factor for determining affiliate conduit status tends to be the last one, which asks whether "the non-U.S. person in the regular course of business, engages in swaps with non-U.S. third-party(ies) for the purpose of hedging or mitigating risks faced by, or to take positions on behalf of, its U.S. affiliate(s), and enters into offsetting swaps or other arrangements with its U.S. affiliate(s) in order to transfer the risks and benefits of such swaps with third-party(ies) to its U.S. affiliates." One can only imagine the amount of money that companies have diverted from their business operations to pay lawyers for advice on parsing the multiple facets of that description.

The failure of the Guidance to clearly articulate, let alone define, an affiliate conduit was a signal that this simply was not a sensible approach. But to be fair, the affiliate conduit concept was a legitimate effort to provide for a situation in which an entity is not a U.S. person and is not guaranteed by a U.S. person, yet presents a significant connection to U.S. commerce and risk to the U.S. financial system.

The proposed rules mercifully abandon affiliate conduits, but propose to achieve their purpose by introducing the concept of an SRS instead. As the name suggests, a significant risk subsidiary is a significant subsidiary of a U.S. person that can impact its ultimate U.S. parent entity and U.S. commerce, and thereby raises the concerns intended to be addressed by the Dodd-Frank swap requirements. But as opposed to the vague and ambiguous description of an affiliate conduit, the metrics for determining whether a non-U.S. entity is an SRS are objective, and they are observable or quantifiable. I welcome comments from the public about whether we have gotten these metrics right. But proposing rules that focus on the pertinent issue of risk to the U.S. financial system, and that define an SRS through objective and measurable criteria, is a sensible approach.

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In sum, I support codifying our prior cross-border Guidance into enforceable rules, and I believe the proposed rules before us today are clear, sensible, and workable. They improve upon the Guidance based on our experience in administering the Dodd-Frank swap regulatory regime over the past several years, and they appropriately recognize the current state of global regulation of globally interconnected derivatives markets.

I therefore support the proposed cross-border rulemaking. I want to thank the staff of the Division of Swap Dealer and Intermediary Oversight, the General Counsel's Office, and the Chief Economist's Office for their efforts in preparing this rulemaking. I also appreciate the quality briefings that we have received, and the time spent answering questions and addressing comments from my team.

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[1] *See* Leaders' Statement from the 2009 G-20 Summit in Pittsburgh, Pa. ("G-20 Pittsburgh Leaders' Statement") at 7 (Sept. 24-25, 2009) ("We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage"), *available at* https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

[2] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292 (July 26, 2013).

[3] Public Law 111-203, 124 Stat. 1376 (2010).

[4] *SIFMA v. CFTC,* 67 F. Supp.3d 373 (2014).

[5] *See* National Futures Association Membership and Directories (data as of November 30, 2019), available at https://www.nfa.futures.org/registration-membership/membership-and-directories.html#SDRegistry. There are no registered MSPs at this time. Accordingly, for convenience, this Statement will hereafter refer only to swap dealers and not MSPs.

[6] *See* Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41214, 41239 (proposed July 12, 2012) (Statement of Commissioner Sommers).

[7] CEA Section 2(i), 7 U.S.C. § 2(i).

[8] I do, however, endorse the discussion of "Principles of International Comity" in this rulemaking release, and believe that it should fully apply to other areas of the Commission's cross-border work as well.

[9] *See* Guidance, 78 Fed. Reg. at 45312 n.214.