SPEECHES & TESTIMONY

Statement of Chairman Heath Tarbert in Support of the Cross-Border Swaps Proposal

December 18, 2019

I am pleased to support the Commission's proposed rule on the cross-border application of registration thresholds and certain requirements for swap dealers and major swap participants. It is critical that the CFTC finalize a sensible cross-border registration rule in 2020, as we approach the 10-year anniversary of the Dodd-Frank Act.

Need for Rule-Based Finality

Since 2013, market participants have been relying on cross-border "interpretive guidance,"[1] which was published outside the standard rulemaking process under the Administrative Procedure Act (APA).[2] Although this policy statement has had a sweeping impact on participants in the global swaps market, it is technically not enforceable. Market participants largely follow the 2013 Guidance, but they are not legally required to do so.[3] Over the intervening years, a patchwork of staff advisories and no-action letters has supplemented the 2013 Guidance. With almost seven years of experience, it is high time for the Commission to bring finality to the issues the 2013 Guidance and its progeny address.

We call this a "cross-border" proposal, and in certain respects it is. For example, the proposed rule addresses when non-U.S. persons must count dealing swaps with U.S. persons, including foreign branches of American banks, toward the *de minimis* threshold in our swap dealer definition. More fundamentally, however, the proposed rule answers a basic question: What swap dealing activity *outside* the United States should trigger CFTC registration and other requirements?

Congressional Mandate

To answer this question, we must turn to section 2(i) of the Commodity Exchange Act ("CEA"), a provision Congress added in Title VII of the Dodd-Frank Act.[4] Section 2(i) provides that the CEA does not apply to swaps activities outside the United States except in two circumstances: (1) where activities have a "direct and significant connection with activities in, or effect on, commerce of the United States" or (2) where they run afoul of the Commission's rules or regulations that prevent evasion of Title VII.[5] Section 2(i) evidences Congress's clear intent for the U.S. swaps regulatory regime to stop at the water's edge, except where foreign activities either are closely and meaningfully related to U.S. markets or are vehicles to evade our laws and regulations.

I believe the proposed rule before us today is a levelheaded approach to the exterritorial application of our swap dealer registration regime and related requirements. The proposed rule would fully implement the congressional mandate in section 2(i). At the same time, it acknowledges the important role played by the CFTC's domestic and international counterparts in regulating what is a global swaps market. In short, the proposal employs neither a full-throated "intergalactic commerce clause"[6] nor an isolationist mentality. It is thoughtful and balanced.

Guiding Principles for Regulating Foreign Activities

For my part, I am guided by three additional principles in considering the extent to which the CFTC should make full use of its extraterritorial powers.

1. Protect the National Interest

An important role of the CFTC is to protect and advance the interests of the United States. In this instance, Congress provided the CFTC with explicit extraterritorial power to safeguard the U.S. financial system where swaps activities are concerned. We need to think continually about the potential outcome for American taxpayers. We cannot have a regulatory framework that incentivizes further bailouts of large financial institutions. We therefore need to ensure that risk created outside the United States does not flow back into our country.

But it is not just any risk outside the United States that we must guard against. Congress made that clear in section 2(i). We must not regulate swaps activities in far flung lands simply to prevent every risk that might have a nexus to the United States. That would be a markedly poor use of American taxpayers' dollars. It would also divert the CFTC from channeling our resources where they matter the most: to our own markets and participants. The proposal therefore focuses on instances when material risks from abroad are most likely to come back to the United States and where no one but the CFTC is responsible for those risks.

Hence, guarantees of offshore swaps by U.S. parent companies are counted toward our registration requirements because that risk is effectively underwritten and borne in the United States. The same is true with the concept of a "significant risk subsidiary" (SRS). An SRS is a large non-U.S. subsidiary of a large U.S. company that deals in swaps outside the United States but (1) is not subject to comparable capital and margin requirements in its home country, and (2) is not a subsidiary of a holding company subject to consolidated supervision by an American regulator, namely the Federal Reserve Board. As a consequence, our cross-border rule would require an SRS to register as a swap dealer or major swap participant with the CFTC if the SRS exceeds the same registration thresholds as a U.S. firm operating within the United States. The national interest demands it.[7]

2. Follow Kant's Categorical Imperative

Rarely does the name of Immanuel Kant, the famous 18th century German philosopher, come up when talking about financial regulation.[8] One of the lasting contributions Kant made to Western thought was his concept of the "categorical imperative." In deducing the laws of ethical behavior, *i.e.,* how people should treat one another, he came up with a simple test: We should act according to the maxim that we wish all other rational people to follow, as if it were a universal law.[9] Kant's categorical imperative is also a good foundation for considering cross-border rulemaking here at the CFTC.

What I take from it is that we should adopt a regulatory regime that we would like all other jurisdictions to follow as if it were a universal law. How does this work? Let me start by explaining how it does not work. If we impose our regulations on non-U.S. persons whenever they have a remote nexus to the United States, then we should be willing for all other jurisdictions to do the same. The end result would be absurdity, with everyone trying to regulate everyone else. And the duplicative and overlapping regulations would inevitably lead to fragmentation in the global swaps market—itself a potential source of systemic risk.[10] Instead, we should adopt a framework that applies CFTC regulations outside the United States only when it addresses one or more important risks to our country.

Furthermore, we should afford comity to other regulators who have adopted comparable regulations, just as we expect them to do for us. This is especially important when we evaluate whether foreign subsidiaries of U.S. parents could pose a significant risk to our financial system. The categorical imperative leads us to an unavoidable result: We should not impose our regulations on the non-U.S. activities of non-U.S. companies in those jurisdictions that have comparable capital and margin requirements to our own.[11] By the same token, when U.S. subsidiaries of foreign companies operate within our borders, we expect them to follow our laws and regulations and not apply rules from their home country.

Charity, it is often said, begins at home. The categorical imperative further compels us to avoid duplicating the work of other American regulators. If a foreign subsidiary of a U.S. financial institution is subject to consolidated regulation and supervision by the Federal Reserve Board, then we should rely on our domestic counterparts to do their jobs when it is a question of dealing activity outside the United States. The Federal Reserve Board has extensive regulatory and supervisory tools to ensure a financial holding company is prudent in its risk taking at home and abroad.[12] The CFTC does not have similar experience, and therefore should focus on regulating dealing activity within the United States or with U.S. persons.

3. Pursue SEC Harmonization Where Appropriate

In the jurisdictional fight over swaps, Congress split the baby between the CFTC and the SEC in Title VII of the Dodd-Frank Act.[13] The SEC got jurisdiction over security-based swaps, and we got jurisdiction over all other swaps—the vast majority of the current market.[14] Congress also required both Commissions to consult and coordinate our respective regulatory approaches, and required us to treat economically similar entities or products in a similar manner.[15] Simple enough, right? Wrong.

The CFTC and the SEC could not even agree on a basic concept that is not even particular to financial regulation: who is a "U.S. person." In what can only be described as a bizarre series of events, the CFTC and the SEC adopted different definitions of "U.S. person" in our respective cross-border regimes. I find it surreal that two federal agencies that regulate similar products pursuant to the same title of the same statute—with an explicit mandate to "consult and coordinate" with each other—have not agreed until today on how to define "U.S. person." This failure to coordinate has increased operational and compliance costs for market participants.[16] And that is why I am pleased that our proposal uses the same definition of U.S. person that is in the SEC's cross-border rulemaking.

To be sure, as my colleagues have said on several occasions, we should not harmonize with the SEC merely for the sake of harmonization.[17] I agree that we should harmonize only if it is sensible. In the first instance, we must determine whether Congress has explicitly asked us to do something different or implicitly did so by giving us a different statutory mandate. It also requires us to consider whether differences in our respective products or markets warrant a divergent approach. Just as the proposed rule takes steps toward harmonization, it also diverges where appropriate.

The prime example is the approach we have taken with respect to "ANE Transactions."[18] ANE Transactions are swap (or security-based swap) transactions between two non-U.S. persons that are "arranged, negotiated, or executed" by their personnel or agents located in the United States, but booked to entities outside America. While some or all of the front-end sales activity takes place in the United States, the financial risk of the transactions resides overseas.

Here, key differences in the markets for swaps and security-based swaps are dispositive. The swaps market is far more global than the security-based swaps market is. While commodities such as gold and oil are traded throughout the world, equity and debt securities trade predominantly in the jurisdictions where they were issued. For this reason, security-based swaps are inextricably tied to the underlying security, and vice versa. This is particularly the case with a single-name credit default swap. The arranging, negotiating, or execution of this kind of security-based swap is typically done in the United States because the underlying reference entity is a U.S. company. Because security-based swaps can affect the price and liquidity of the underlying security, the SEC has a legitimate interest in requiring these transactions to be reported. By contrast, because commodities are traded throughout the world, there is less need for the CFTC to apply its swaps rules to ANE Transactions.[19]

In addition, as noted above, Congress directed the CFTC to regulate foreign swaps activities outside the United States that have a "direct and significant" connection to our financial system. Congress did not give a similar mandate to the SEC. As a result of its different mandate, the SEC has not crafted its cross-border rule to extend to an SRS engaged in swap dealing activity offshore that may pose a systemic risk to our financial system. Our proposed rule does, aiming to protect American taxpayers from another Enron conducting its swaps activities through a major foreign subsidiary.[20]

Conclusion

In sum, the proposed rule before us today represents a critical step toward finalizing the regulations Congress asked of us nearly a decade ago. I believe our proposal is also a sensible and principled approach to addressing when foreign transactions should fall within the CFTC's swaps registration and related requirements.

Perhaps President Eisenhower said it best: "The world must learn to work together, or finally it will not work at all."[21] My sincere hope is that our domestic and international counterparts will view this proposal as a concrete step toward working together to provide sound regulation to the global swaps market.

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[1] Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45292 (Jul. 26, 2013) ("2013 Guidance"), http://www.cftc.gov/idc/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf.

[2] 5 U.S.C. 551 *et seq*.

[3] As then Commissioner Scott O'Malia pointed out regarding the 2013 Guidance: "Legally binding regulations that impose new obligations on affected parties—'legislative rules'—must conform to the APA." Appendix 3—Dissenting Statement of Commissioner Scott D. O'Malia, 2013 Guidance at 45372 (citing *Chrysler Corp. v. Brown*, 441 U.S. 281, 302–03 (1979) (agency rulemaking with the force and effect of law must be promulgated pursuant to the procedural requirements of the APA)).

[4] 7 U.S.C. 2(i).

[5] *Id.*

[6] *See* Commissioner Jill E. Sommers, Statement of Concurrence: (1) Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, Proposed Interpretive Guidance and Policy Statement; (2) Notice of Proposed Exemptive Order and Request for Comment Regarding Compliance with Certain Swap Regulations (June 29, 2012), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement062912 (noting that "staff had been guided by what could only be called the 'Intergalactic Commerce Clause' of the United States Constitution, in that every single swap a U.S. person enters into, no matter what the swap or where it was transacted, was stated to have a direct and significant connection with activities in, or effect on, commerce of the United States").

[7] The SRS concept has been designed to address a potential situation where a U.S. entity establishes an offshore subsidiary to conduct its swap dealing business without an explicit guarantee on the swaps in order to avoid the Dodd-Frank Act. For example, the U.S.-regulated insurance company American International Group ("AIG") nearly failed as a result of risk incurred by the London swap trading operations of its subsidiary AIG Financial Products. *See, e.g.*, Congressional Oversight Panel, June Oversight Report, *The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy* (June 10, 2010), available at: http://www.gpo.gov/fdsys/pkg/CPRT–111JPRT56698/pdf/CPRT–111JPRT56698.pdf. If the Commission did not regulate SRS, an AIG-type entity could establish a non-U.S. affiliate to conduct its swaps dealing business, and, so long as it did not explicitly guarantee the swaps, it would avoid application of the Dodd-Frank Act and bring risk created offshore back into the United States without appropriate regulatory safeguards.

[8] Yet even at first glance, derivatives regulation and Kant's philosophy share some strikingly common attributes. Title 17 of the Code of Federal Regulation (CFR) and *The Critique of Pure Reason* (*Kritik der reinen Vernunft*) (1781) are impenetrable to all but a handful of subject matter experts. And scholars spend decades writing and thinking about them, often coming up with more questions than answers.

[9] "Act only according to that maxim whereby you can, at the same time, will that it should become a universal law." Immanuel Kant, *Grounding for the Metaphysics of Morals* (1785) [1993], translated by James W. Ellington (3rd ed.).

[10] *See* FSB Report on Market Fragmentation (June 4, 2019), available at: https://www.fsb.org/wp-content/uploads/P040619-2.pdf.

[11] *See, e.g.,* Comments of the European Commission in respect of CFTC Staff Advisory No. 13-69 regarding the applicability of certain CFTC regulations to the activity in the United States of swap dealers and major swap participants established in jurisdictions other than the United States (Mar. 10, 2014), available at: https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59781&SearchText= ("In order to ensure that cross-border activity is not inhibited by the application of inconsistent, conflicting or duplicative rules, regulators must work together to provide for the application of one set of comparable rules, where our rules achieve the same outcomes. Rules should therefore include the possibility to defer to those of the host regulator in most cases.").

[12] For example, the Federal Reserve Board requires all foreign branches and subsidiaries "to ensure that their operations conform to high standards of banking and financial prudence." 12 C.F.R. § 211.13(a)(1). Furthermore, they are subject to examinations on compliance. *See* Bank Holding Company Supervision Manual, Section 3550.0.9 ("The procedures involved in examining foreign subsidiaries of domestic bank holding companies are generally the same as those used in examining domestic subsidiaries engaged in similar activities.").

[13] This was unfortunately nothing new. On a number of occasions prior to the Dodd-Frank Act, the CFTC and SEC fought over jurisdiction of certain derivative products. *See, e.g.,* In Board of Trade of the City of Chicago v. Securities and Exchange Commission, 677 F. 2d 1137 (7th Cir. 1982) (finding that the SEC lacked the authority to approve CBOE to trade options on mortgage-backed securities because the options fell within the CFTC's exclusive jurisdiction).

[14] The swaps market is significantly larger than the security-based swaps market. Aggregating across all major asset classes in the global derivatives market, dominated by interest rates and FX, the ratio exceeds 95% swaps to 5% security-based swaps by notional amount outstanding. This ratio holds even with relatively conservative assumptions like assigning all equity swaps (a small asset class) to the security-based swaps category. *See* Bank for International Settlements, OTC derivatives outstanding (Updated 8 December 2019), available at: https://www.bis.org/statistics/derstats.htm.

[15] *See* Section 712(a)(7) of the Dodd-Frank Act.

[16] *See, e.g.,* Futures Industry Association Letter re: Harmonization of SEC and CFTC Regulatory Frameworks (Nov. 29, 2018), available at: https://fia.org/articles/fia-offers-recommendations-cftc-and-sec-harmonization.

[17] *See, e.g.,* Dissenting Statement of Commissioner Dan M. Berkovitz, Rulemaking to Provide Exemptive Relief for Family Office CPOs: Customer Protection Should be More Important than Relief for Billionaires (Nov. 25, 2019), available at: https://www.cftc.gov/PressRoom/SpeechesTestimony/berkovitzstatement112519 ("The Commission eliminates the notice requirement largely on the basis that this will harmonize the Commission's regulations with those of the SEC. Harmonization for harmonization's sake is not a rational basis for agency action.").

[18] *See* SEC, Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, 84 Fed. Reg. 24206 (May 24, 2019), available at: https://www.govinfo.gov/content/pkg/FR-2019-05-24/pdf/2019-10016.pdf.

[19] Under the proposal, persons engaging in any aspect of swap transactions within the United States remain subject to the CEA and Commission regulations prohibiting the employment, or attempted employment, of manipulative, fraudulent, or deceptive devices, such as section 6(c)(1) of the CEA (7 U.S.C. § 9(1)) and Commission regulation 180.1 (17 C.F.R. § 180.1). The Commission thus would retain anti-fraud and anti-manipulation authority, and would continue to monitor the trading practices of non-U.S. persons that occur within the territory of the United States in order to enforce a high standard of customer protection and market integrity. Even where a swap is entered into by two non-U.S. persons, we have a significant interest in deterring fraudulent or manipulative conduct occurring within our borders, and we cannot let our country be a haven for such activity.

[20] The SEC's cross-border rule would, however, appear to extend to a foreign-to-foreign transaction *not* involving the arranging, negotiation, or execution of the trade in the United States if the transaction involved an SEC-registered broker-dealer.

[21] Transcript of President Dwight D. Eisenhower's Farewell Address (1961), available at: https://www.ourdocuments.gov/doc.php?flash=true&doc=90&page=transcript.