PROMOTING U.S. ACCESS TO NON-U.S. SWAPS MARKETS:

A ROADMAP TO REVERSE FRAGMENTATION

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Introduction

The increase in multilateral trading and central clearing of swaps markets since Congress enacted the Dodd-Frank Act increases the need for U.S. firms to have effective access to non-U.S. swaps trading venues and central counterparties ("CCPs"). Most of the recent efforts of the Commodity Futures Trading Commission ("CFTC") in this area have focused on addressing when and to what extent it will defer to comparable foreign regulation of a non-U.S. trading venue or CCP that is subject to registration with the CFTC as a swap execution facility ("SEF") or derivatives clearing organization ("DCO"), respectively. This paper complements those efforts by addressing when a non-U.S. swaps trading venue or CCP has a sufficient U.S. nexus to trigger registration as a SEF or DCO in the first place.

The CFTC initially developed its approach to regulating non-U.S. swaps trading venues and CCPs through staff no-action letters and guidance adopted during the early stages of Dodd-Frank Act implementation. That initial approach led to several problems. U.S. firms were forced off swaps trading venues in numerous jurisdictions stretching across the European Union ("EU") and Asia. U.S. banks were forced to subsidiarize their operations in order to access certain local CCPs. U.S. customers can access only five non-U.S. swaps CCPs, only one of which is located outside the EU.

Recent steps by the CFTC—most notably the adoption of a common approach with the European Commission ("EC") toward trading venue regulation[1]—signal a

[1] *See* "The U.S. [CFTC] and the [EC]: A Common Approach to Certain Derivatives Trading Venues" (Oct. 13, 2017) (link); *see, also* Order of Exemption, In the Matter of the Exemption of Multilateral Trading Facilities and Organised Trading Facilities Authorized Within the European Union from the Requirement to Register with the Commodity Futures Trading Commission as Swap Execution Facilities

positive new direction toward robust mutual recognition of comparable regulation. Mutual recognition is essential to preventing fragmentation between jurisdictions that apply overlapping mandatory trading or clearing requirements, such as the U.S. and EU. We strongly support the decision by the CFTC and EC to adopt their new common approach.

Mutual recognition alone will not fully address market fragmentation, however. Before it can defer to a foreign regulatory regime, the CFTC must assess whether that regime is comparable to CFTC trading venue or CCP regulation. This assessment process is time- and resource-intensive. It is not suitable for jurisdictions where use of swaps trading venues or CCPs is still developing. But without an effective approach to permitting U.S. access to those venues and CCPs, U.S. firms will face diminished hedging and investment opportunities. U.S. firms might also miss out on the formation of the next important market before it is too late. Foreign competitors may not face similar limitations.

Relying solely on mutual recognition also invites reciprocal treatment by foreign jurisdictions. If U.S. firms cannot participate in a foreign jurisdiction's trading venues or CCPs unless the venues or CCPs register with the CFTC or the CFTC makes comparability determinations for that jurisdiction, then why should that jurisdiction permit its local firms to participate in U.S. designated contract markets ("DCMs"), SEFs or DCOs without imposing similar conditions? Given the large number of foreign

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(Dec. 8, 2017); and Commission Implementing Decision on the equivalence of the legal and supervisory framework applicable to designated contract markets and swap execution facilities in the United States of America in accordance with Regulation (EU) No 600/2014 of the European Parliament and of the Council.

jurisdictions represented among firms participating directly or indirectly in U.S. DCMs, SEFs and DCOs, such a reciprocal approach would result in significant overlapping foreign regulation of, or diminished foreign participation in, U.S. markets.

The CFTC previously encountered these considerations during the internationalization of the futures markets in the 1980s and 1990s. It addressed them by pairing a robust program for deference to comparable foreign regulation with clear and appropriately targeted tests for when a foreign board of trade ("FBOT"), its clearing organization and members must register with the CFTC. In contrast, in the swaps markets, the tests for SEF and DCO registration are broad and ambiguous.

This paper proposes a revised approach to cross-border application of SEF and DCO registration requirements that is clear, predictable, consistent with the Dodd-Frank Act's text and founded on the tried and true approach applicable to the futures markets. The proposed approach also hews more closely to how the Securities and Exchange Commission ("SEC") has addressed similar issues in the securities markets, as well as how the SEC has proposed to implement the Dodd-Frank Act's security-based swap regulations.

Under the proposed approach, a non-U.S. swaps trading venue or CCP would not be required to register with the CFTC or obtain an exemption from registration unless it permitted direct, un-intermediated participation by a U.S. person (other than the foreign branch of a U.S. bank swap dealer) or directly solicited U.S. participation. In addition, U.S. firms subject to the Dodd-Frank Act's mandatory trading and clearing requirements could not satisfy those requirements by using a non-U.S. trading venue or

CCP unless the venue or CCP was registered or exempt from registration as a SEF or DCO, respectively. In each case, a non-U.S. swaps trading venue or CCP would be eligible for an exemption from registration on the basis of comparable home country regulation if its home country regulatory regime was consistent with relevant international regulatory standards. Conditions on these exemptions would apply only where necessary to satisfy the CFTC's mandate under Section 2(i) of the Commodity Exchange Act ("CEA") to mitigate "direct and significant" risk to the U.S.

Overall, the proposed approach is designed to look to the extraterritorial character of activity by non-U.S. swaps trading venues and CCPs, the risk of that activity to the U.S. and the extent to which that risk is already adequately addressed by existing regulation of the trading venue, CCP or its members. In so doing, the proposed approach would mitigate risk to the U.S. financial system and protect U.S. customers, while also expanding U.S. firms' hedging and investment opportunities, making efficient use of regulatory resources and avoiding incentives for foreign regulation of U.S. markets. The proposed approach would also expand the range of services that U.S. intermediaries can provide to their customers, while reducing the costs and risks of providing those services.

I. U.S. Access to Non-U.S. Swaps Trading Venues

A. Background

The implementation of the Dodd-Frank Act's SEF registration requirement in October 2013 and its mandatory trading requirement in February 2014 drove fragmentation of the global swaps markets by forcing non-U.S. swaps trading venues to

deny participation by U.S. firms. The most well-chronicled example involves trading in euro-denominated interest rate swaps, where the October 2013 implementation of the SEF registration requirement led to a sharp drop in U.S. dealers' share of trading in Europe from over 25% to less than 10%.[2] U.S. firms have also faced impediments to trading on non-U.S. venues for other types of swaps, including swaps (such as foreign exchange derivatives) that are not covered by the Dodd-Frank Act's mandatory trading requirement. As noted by Chairman Giancarlo, the smaller liquidity pools that result from these impediments "are less resilient to market shocks and less supportive of global economic growth."[3] By expanding and clarifying the circumstances under which U.S. firms can access non-U.S. swaps trading venues, the CFTC can help to reverse these trends and promote markets that are more liquid and resilient.

B. Applicable Legal Requirements

1. SEF Registration Requirement

The Dodd-Frank Act amended the CEA to set forth a territorial test for SEF registration. This test is reflected in the SEF definition itself, which encompasses "a trading system or platform in which multiple participants have the ability to execute or trade swaps by accepting bids and offers made by multiple participants in the facility or

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[2] International Swaps and Derivatives Association ("ISDA"), Cross-Border Fragmentation of Global Interest Rate Derivatives: Second Half 2015 Update (May 2016) (link).

[3] Chairman J. Christopher Giancarlo, "Changing Swaps Trading Liquidity, Market Fragmentation and Regulatory Comity in Post-Reform Global Swaps Markets," Remarks before ISDA's 32nd Annual Meeting (May 10, 2017) (link).

system, *through any means of interstate commerce.*"[4] Although the CFTC's analysis of the SEF definition's "interstate commerce" language has generally focused on the technological means employed by a trading venue to execute swaps,[5] the language also adopts a territorial scope for the SEF definition because the CEA's "interstate commerce" definition is limited to commerce within or with the territorial U.S.[6]

The CFTC has in turn interpreted the CEA's SEF registration requirement to apply only to venues that meet the SEF definition.[7] The CFTC has not tied this interpretation to whether a venue lists swaps subject to the Dodd-Frank Act's mandatory trading requirement. Rather, in a footnote to its SEF Final Rule release ("footnote 88"), the CFTC explained that a venue "would be required to register as a SEF if it operates in a manner that meets the SEF definition even though it only executes or trades swaps that are not subject to the trade execution mandate."[8]

The CFTC has not addressed the SEF definition's "interstate commerce" language when it has addressed the cross-border application of the SEF registration requirement. Instead, in a November 2013 guidance letter (the "November 2013

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4 CEA § 1a(50) (emphasis added).

5 *See* Core Principles and Other Requirements for [SEFs], 78 Fed Reg. 33,476, 33,501 (June 4, 2013) (the "SEF Final Rule").

6 *See* CEA § 1a(30).

7 SEF Final Rule, n.5, at 33,581 ("[T]he Commission views the CEA section 5h(a)(1) registration requirement as applying only to facilities that meet the SEF definition in CEA section 1a(50)"). We note, however, that the CFTC's implementation of this interpretation in CFTC Regulations § 37.3 omits the "interstate commerce" language in the SEF definition. It would be appropriate for the CFTC to amend CFTC Regulations § 37.3 to restore that language.

8 *Id.* at 33,481 n.88.

Guidance"), CFTC staff took the position that the SEF registration requirement "may apply to a multilateral swaps trading platform that is located outside the United States where the trading or executing of swaps on or through the platform creates a 'direct and significant' connection to activities in, or effect on, commerce of the United States."[9]

The November 2013 Guidance justifies this position by reference to CEA Section 2(i), which generally applies the CEA's swaps provisions and regulations thereunder to non-U.S. activities that "have a direct and significant connection with activities in, or effect on, commerce of the United States." However, it is a longstanding principle of statutory construction that, when a more specific provision conflicts with a more general provision, the more specific provision controls.[10] Thus, one would expect the more specific "interstate commerce" language in the SEF definition to establish the cross-border scope of the SEF registration requirement, not the general "direct and significant" connection or effect language in Section 2(i).

The November 2013 Guidance also does not correctly apply Section 2(i). First, even though Section 2(i) expressly requires a "*direct*" connection with or effect on U.S. commerce, the November 2013 Guidance expands SEF registration to non-U.S. trading

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9 Division of Market Oversight, CFTC, "Guidance on Application of Certain Commission Regulations to [SEFs]" (Nov. 15, 2013) at 2 (link). We note that the mere fact that market participants executing a swap on a non-U.S. trading venue elect to clear that swap at a U.S. DCO should not subject the venue to registration as a SEF. The CFTC's 2013 cross-border guidance supports this interpretation. In applying the direct and significant test to registration of foreign swap dealers, the guidance states that "[t]he [CFTC]'s policy is that a person generally would not be required to register as a swap dealer if the person's only connection to the United States is that the person uses a U.S.-registered [SEF] or [DCM] in connection with its swap dealing activities," indicating that solely using U.S. facilities for executing or clearing swaps is not a "direct and significant" contact with the U.S. *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,324 (July 26, 2013) (the "2013 Cross-Border Guidance").

10 *See* Sutherland Statutes and Statutory Construction (7th ed. 2016), § 51:5.

venues where U.S. participation takes place *indirectly*, through an intermediary.[11] Also, even though Section 2(i) establishes a conjunctive "direct *and* significant" test, the November 2013 Guidance implies that *either* direct solicitation or marketing to the U.S. *or* significant U.S. trading activity (including trading indirectly through intermediaries) is sufficient to require a non-U.S. swaps trading venue to register as a SEF.[12] The November 2013 Guidance further applies these principles to both U.S. persons *and* the U.S.-located personnel and agents of non-U.S. persons,[13] even though the CFTC subsequently scaled back the application of its Dodd-Frank Act rules to the U.S.-located personnel and agents of non-U.S. persons.[14]

The November 2013 Guidance also does not accord with the special treatment of the foreign branches of U.S. bank swap dealers reflected in the CFTC's other interpretations of Section 2(i). Under those interpretations, transacting with a foreign branch does not subject a non-U.S. person to registration with the CFTC.[15] The different approach set forth in the November 2013 Guidance puts U.S. bank swap

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11 *See* Note 9.

12 *See id.* at n.8.

13 *See id.*

14 *See* CFTC Letter No. 17-36 (July 25, 2017) (sixth extension of no-action relief from application of transaction-level rules to certain swaps arranged, negotiated or executed by U.S.-located personnel or agents of non-U.S. persons).

15 *See* 2013 Cross-Border Guidance at 45,324 ("The Commission understands that commenters are concerned that foreign entities, in order to avoid swap dealer status, may decrease their swap dealing business with foreign branches of U.S. registered swap dealers and guaranteed affiliates that are swap dealers. Therefore, the Commission's policy, based on its interpretation of Section 2(i) of the CEA, will be that swap dealing transactions with a foreign branch of a U.S. swap dealer or with guaranteed affiliates that are swap dealers should generally be excluded from the *de minimis* calculations of non-U.S. persons that are not guaranteed or conduit affiliates").

dealers at a competitive disadvantage when trading abroad and impedes their risk management by limiting their ability to hedge in the jurisdictions in which they do business. It also undermines the Dodd-Frank Act's goal of promoting pre-trade transparency by making it more difficult for U.S. bank swap dealers to access liquid, transparent markets outside the U.S. The November 2013 Guidance thus increases, not decreases, risks to the U.S. financial system.

These flaws of the November 2013 Guidance have led to the market fragmentation described in this paper. As the Treasury Department recently noted, "This guidance, combined with other aspects of the CFTC's final SEF rules, prompted non-U.S. trading platforms to exclude U.S. persons to avoid falling under the CFTC's SEF registration and other regulatory requirements, contributing to market fragmentation in certain products."[16] The Treasury Department also expressed concern that footnote 88 of the CFTC's final SEF rule release has "caused most non-U.S. trading platforms to exclude U.S. participants for fear of falling under the CFTC's SEF registration and other regulatory requirements, resulting in fragmented markets and separate liquidity pools and prices for similar transactions."[17]

2. Mandatory Trading Requirement

In addition to requiring a venue that operates as a SEF to register with the CFTC, the Dodd-Frank Act amended the CEA to require that any swap covered by the Dodd-

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[16] Department of the Treasury, "A Financial System That Creates Economic Opportunities: Capital Markets" (Oct. 2017) at 133 (link) ("Treasury Capital Markets Report").

[17] *Id.* at 145.

Frank Act's mandatory trading requirement must be executed on a DCM or a registered or exempt SEF, unless no DCM or SEF makes the swap available to trade.[18] The CFTC has interpreted Section 2(i) to apply this mandatory trading requirement extraterritorially to foreign branches of U.S. bank swap dealers (subject to a 5 percent *de minimis* exception for swaps of a U.S. bank swap dealer's foreign branches in jurisdictions other than Australia, Canada, the European Union, Hong Kong, Japan or Switzerland)[19] and, for their swaps with each other[20] or with non-U.S. swap dealers,[21] guaranteed affiliates of U.S. persons. Substituted compliance is potentially available in each of these cases.

As a result, even if a non-U.S. swaps trading venue is not, under the SEF registration requirement itself, required to register as a SEF, U.S. firms cannot (absent substituted compliance) use the venue to satisfy the Dodd-Frank Act's mandatory trading requirement unless the venue registers as a SEF or qualifies for an exemption from SEF registration. The Dodd-Frank Act further authorized the CFTC, conditionally or unconditionally, to exempt a SEF from registration if the CFTC determines that the SEF is "subject to comparable, comprehensive supervision and regulation by the [SEC] or the appropriate government authorities in the [SEF's] home country."[22]

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18 CEA § 2(h)(8).

19 2013 Cross-Border Guidance, n.15, at 45,350-51.

20 *Id.* at 45,362.

21 *Id.* at 45,355-57.

22 CEA § 5h(g).

C. **Proposed Approach**

As summarized above, the CEA clearly contemplates an approach under which a non-U.S. swaps trading venue is subject to SEF registration only if it provides a multiple-to-multiple trading functionality or service within U.S. interstate commerce. In addition, U.S. firms cannot (absent substituted compliance) use a non-U.S. trading venue to satisfy the Dodd-Frank Act's mandatory trading requirement unless the venue registers as a SEF or qualifies for an exemption from SEF registration. In either case, the trading venue would be eligible for an exemption from SEF registration if it is subject to comparable, comprehensive home country supervision and regulation.

1. Operation Within U.S. Interstate Commerce

(i) Trading by U.S. Customers

In determining whether a non-U.S. swaps trading venue provides or seeks to provide a multiple-to-multiple trading functionality or service within U.S. interstate commerce, the CFTC should look to its longstanding framework for regulating FBOTs. That framework, which Congress codified in the Dodd-Frank Act and the CFTC has incorporated into Part 48 of its regulations, does not subject an FBOT to registration with the CFTC unless the FBOT provides "direct access" to a U.S. member or other participant.[23] The CFTC has explained that "direct access" means that "the FBOT itself,

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[23] *See* CFTC Regulations § 48.3(a) (FBOT registration requirement). The SEC has proposed to take a similar approach in determining when a non-U.S. trading platform must register as a security-based SEF. *See* 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, 78 Fed. Reg. 30,968, 31,054-55 (May 23, 2013).

and not its members or participants, has identified and permitted a member or participant to enter trades directly into the FBOT's order matching and trade entry system from the U.S."[24] In contrast, a person that transmits orders to an FBOT through a non-U.S. intermediary does not have "direct access."[25]

Instead of regulating FBOTs accessed indirectly by U.S. persons, the CFTC regulates the intermediaries providing U.S. persons with such access. Specifically, Part 30 of the CFTC's regulations ("Part 30") requires the intermediary to register as an introducing broker ("IB") or futures commission merchant ("FCM") under CFTC Regulations § 30.4 ("Rule 30.4"), qualify for an exemption from such registration on the basis of comparable home country regulation under CFTC Regulations § 30.10 ("Rule 30.10"), or qualify for an exemption permitting direct order transmittal by certain sophisticated U.S. customers under CFTC Regulations § 30.12.

One notable distinction between the futures and swaps markets, however, is that the CEA requires *all* futures contracts to be executed on or subject to the rules of a DCM or FBOT,[26] whereas the Dodd-Frank Act amended the CEA to require that a swap be executed on a DCM or SEF *only* if the swap is subject to mandatory clearing and made available to trade by a DCM or SEF.[27] Thus, a truly parallel approach between the futures and swaps markets would involve eliminating footnote 88, as the Treasury

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[24] Registration of [FBOTs], 77 Fed. Reg. 80,674, 80,688 (Dec. 23, 2011).

[25] *Id.*

[26] CEA § 4(a).

[27] CEA § 2(h)(8).

Department has recommended,[28] and applying the SEF registration requirement only to a venue providing a multiple-to-multiple trading functionality or service within U.S. interstate commerce in connection with swaps subject to the Dodd-Frank Act's mandatory trading requirement.

Whether or not the CFTC eliminates footnote 88, however, it should amend the November 2013 Guidance by providing that the SEF registration requirement will *not* apply to a non-U.S. swaps trading venue solely because it permits *indirect* U.S. participation through regulated intermediaries, so long as the venue has not directly solicited such participation by initiating contact with U.S. persons for the purpose of inducing such persons to trade on the venue. As a corollary, the CFTC should grant exemptions from IB and FCM registration permitting non-U.S. executing brokers to handle U.S. customer orders to enter into swaps in a manner similar to how they handle U.S. customer orders to enter into futures contracts under Part 30.

By relying on direct U.S. regulation of intermediaries (including disclosure requirements and professional standards of conduct), as opposed to extraterritorial regulation of non-U.S. swaps trading venues, these steps would expand U.S. access to non-U.S. markets without compromising U.S. customer protection or market integrity objectives. Although such indirect access arrangements are not the current market standard for access to swaps trading venues, experience with these arrangements in the futures markets suggests that expanding their use into the swaps markets would provide a beneficial method for promoting liquidity and averting market fragmentation.

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[28] *See* Treasury Capital Markets Report, n.16, at 145.

Doing so would also enhance the role played by professional U.S. intermediaries in facilitating cross-border swap market executions.

(ii) Trading by Foreign Branches of U.S. Bank Swap Dealers

The CFTC should also clarify that the SEF registration requirement does *not* apply to a non-U.S. swaps trading venue solely because it permits participation (direct or indirect) by foreign branches of U.S. bank swap dealers. Because such participation takes place outside the U.S., it does not fall within the SEF definition's "interstate commerce" language. In addition, the CFTC has recognized in other contexts that applying the Dodd-Frank Act's registration requirements extraterritorially to parties transacting with the foreign branches of U.S. bank swap dealers would result in competitive disparities that are not necessary to mitigate risk to the U.S.[29] These considerations apply even more strongly in connection with a foreign branch's access to a non-U.S. swaps trading venue. Unlike entering into bilateral swaps with a non-U.S. counterparty, accessing a non-U.S. swaps trading venue does not present a vector for transmitting risk to the U.S. through the foreign branch. Rather, such access *reduces* risk by permitting U.S. banks to hedge in the most liquid, transparent markets available in the jurisdictions where they do business.

2. Satisfaction of the Mandatory Trading Requirement

Regardless of whether or not a non-U.S. swaps trading venue triggers the SEF registration requirement by operating within U.S. interstate commerce, U.S. firms could

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[29] *See* Note 15.

not (absent substituted compliance) use the venue to satisfy the Dodd-Frank Act's mandatory trading requirement unless the venue registered as a SEF or qualified for an exemption from SEF registration. For example, even if a U.S. investment fund was trading swaps on a non-U.S. venue indirectly through a U.S. IB or FCM routing the fund's orders to a non-U.S. member of the venue, the venue would still need to register as a SEF or qualify for a SEF registration exemption if the U.S. investment fund wanted to use the venue to satisfy the Dodd-Frank Act's mandatory trading requirement.

As a result, a non-U.S. trading venue listing swaps "made available to trade" in the U.S. would need to register with the CFTC as a SEF or obtain an exemption from such registration in order to attract U.S. firms trading in those swaps. This increased level of U.S. regulation for cross-border trading in swaps that are "made available to trade" would help ensure that, for the most liquid types of swaps exhibiting the requisite degree of standardization and fungibility for trading venues to compete head-to-head in listing those swaps, U.S.-regulated SEFs do not face competition from non-U.S. venues lacking comparable regulation.

3. Exemptions for Comparably Regulated Trading Venues

Qualification for an exemption from SEF registration should depend solely on an outcomes-based analysis of the comparability of a non-U.S. trading venue's home country regulatory regime to the CFTC's requirements for SEFs.[30] Consistent with its recent approach to EU trading venues, the CFTC should not additionally require a

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[30] For a discussion of this approach, *see* ISDA, "Principles for US/EU Trading Platform Recognition" (Feb. 2016) (link).

comparably regulated non-U.S. trading venue to satisfy particular U.S. SEF requirements (such as those relating to particular trading functionalities) in order to qualify for an exemption from registration. CEA Section 2(i) only permits such extraterritorial application of CFTC swaps regulation where necessary to address a "direct and significant" risk to the U.S.[31] Operation of a trading venue does not present a vector for transmitting such risk.

II. U.S. Access to Non-U.S. Swaps CCPs

A. Background

Commencing in 2012, the CFTC developed an approach to regulating non-U.S. swaps CCPs that covered the two primary clearing models that had taken root by that time: (1) clearing for U.S. customers by U.S. FCMs that were direct clearing members of a non-U.S. swaps CCP already registered as a DCO[32] and (2) proprietary clearing by U.S. banks at non-U.S. swaps CCPs subject only to home country regulation.[33] The

[31] The CFTC has indicated that it interprets CEA Section 2(i)'s "direct and significant" test "in a manner consistent with the overall goals of the Dodd-Frank Act to reduce risks to the U.S. financial system and avoid future financial crises." 2013 Cross-Border Guidance, n.15, at 45,300.

[32] For example, LCH Ltd. has been registered as a DCO since 2001 and offered clearing by U.S. customers through U.S. FCMs since 2011. *See* LCH, "LCH.Clearnet's SwapClear FCM Service Launches" (Mar. 9, 2011) (link). Staff no-action relief addressing non-U.S. swaps CCPs offering clearing to U.S. customers built on this model. *See* CFTC No-Action Letter No. 12-63 (Dec. 21, 2012) (relief to Singapore Exchange Derivatives Clearing Limited designed to transition to DCO registration).

[33] *See, e.g.*, CFTC No-Action Letter No. 12-56 (Dec. 17, 2012) (relief permitting Japan Securities Clearing Corporation to allow proprietary clearing by U.S. participants).

CFTC later formalized this approach through registration[34] or exemption[35] of the relevant CCPs.[36] The CFTC also forged an equivalence agreement with the EU permitting EU CCPs dually registered as DCOs to substitute compliance with specified EU regulations for compliance with specified CFTC regulations.[37]

Although this approach has generally addressed existing swaps clearing models, over time it will become important to afford market participants additional flexibility. In particular, new mandatory clearing requirements in some foreign jurisdictions require U.S. banks to expand use of local CCPs. Some of those CCPs have already required U.S. banks to participate through local subsidiaries instead of branches for fear of triggering the CFTC's DCO registration requirement. Establishing a new local subsidiary is an onerous undertaking for banks that typically requires the approval of both home country and local regulators.

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[34] *See* Order of Registration as a DCO (Feb. 1, 2016) (Eurex Clearing AG); Amended Order of DCO Registration (Sept. 23, 2015) (ICE Clear Europe Limited); Amended Order of Registration as a DCO (Dec. 16, 2014) (LCH.Clearnet Limited); Order of DCO Registration (Dec. 17, 2013) (LCH.Clearnet SA); and Order of DCO Registration (Dec. 27, 2013) (Singapore Exchange Derivatives Clearing Ltd.).

[35] *See* Amended Order of Exemption from Registration (Jan. 28, 2016) (ASX Clear (Futures) Pty Limited), Amended Order of Exemption from DCO Registration (May 15, 2017) (Japan Securities Clearing Corporation), Order of Exemption from DCO Registration (Oct. 26, 2015) (Korea Exchange, Inc.) and Order of Exemption from DCO Registration (Dec. 21, 2015) (OTC Clearing Hong Kong Limited). Also, the CFTC staff has granted temporary no-action relief (until February 28, 2018) to a Chinese CCP pending an exemption. CFTC Letter No. 17-62 (Nov. 20, 2017).

[36] This approach is also reflected in the CFTC's recent SEF registration exemption for EU trading venues. *See* Order of Exemption, In the Matter of the Exemption of Multilateral Trading Facilities and Organised Trading Facilities Authorized Within the European Union from the Requirement to Register with the Commodity Futures Trading Commission as Swap Execution Facilities (Dec. 8, 2017) at paragraph 3.

[37] *See* "The United States [CFTC] and the [EC]: Common approach for transatlantic CCPs" (Feb. 10, 2016) (link); *see, also* Comparability Determination for the European Union: Dually-Registered DCOs and CCPs, 81 Fed. Reg. 15,260 (Mar. 22, 2016) and CFTC Letter No. 16-26 (Mar. 16, 2016) (no-action relief for EU DCO/CCPs).

Further, continued implementation of initial margin requirements for uncleared swaps will increase incentives for U.S. customers to centrally clear a wider range of swaps in a larger number of jurisdictions. The CFTC should seek to promote this additional central clearing in a manner that is efficient and scalable for market participants and regulators alike.

In addition, a recent proposal by the EC to modify its regulatory approach to non-EU CCPs[38] would potentially modify the existing CFTC-EU equivalence agreement by imposing additional EU regulations on U.S. DCOs. To the extent that proposal draws from the DCO registration and regulatory requirements that apply to certain EU CCPs, clarifying why those requirements apply to those EU CCPs would also help to clarify when such dual regulation is appropriate. In particular, it would be helpful to clarify that the CFTC's dual regulation approach applies where U.S. FCMs are direct members of EU CCPs for purposes of clearing swaps for U.S. customers; no analogous situation exists in the context of U.S. CCPs vis-a-vis EU firms.

B. Applicable Legal Requirements

1. DCO Registration Requirement

The Dodd-Frank Act amended Section 5b of the CEA to require a non-U.S. CCP to register as a DCO if it makes "use of the mails or any means or instrumentality of

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[38] Commission Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No. 1095/2010 Establishing a European Supervisory Authority (European Securities and Markets Authority) and Amending Regulation (EU) No 648/2012 as Regards the Procedures and Authorities Involved for the Authorization of CCPs and Requirements for the Recognition of Third-Country CCPs, COM (2017) 331 final (Jun. 13, 2017) (link).

interstate commerce to perform the functions of a [DCO]" with respect to swaps.[39] This jurisdictional means test for when a non-U.S. CCP must register as a DCO to clear swaps is identical to the test that the CEA applies to a non-U.S. CCP that clears futures contracts. It is also the same test that the Securities Exchange Act of 1934 (the "Exchange Act") applies for when a non-U.S. CCP clearing securities (including security-based swaps) must register with the SEC as a clearing agency.[40]

Given Congress's express decision to amend the CEA to apply the same registration test to a CCP that clears swaps as a CCP that clears futures contracts or security-based swaps, it would conflict with congressional intent to apply a different test to one product type relative to another. Although Section 2(i) of the CEA establishes a somewhat different test for when other provisions of the CEA apply to non-U.S. swaps activities, the better reading of the CEA is that the more specific language in Section 5b's DCO registration requirement controls over the more general language in Section 2(i).[41]

Moreover, the same U.S. policy interests are implicated when a non-U.S. CCP clears swaps for a U.S. person as when it clears futures contracts or security-based swaps. Each type of product gives rise to a similar type of credit exposure, resulting in the need for risk-calibrated margin requirements and other risk management measures to mitigate systemic risk. For each product type, the use of clearing intermediaries to

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[39] CEA § 5b(a)(1).

[40] Exchange Act § 17A.

[41] *See, also* Note 10 and accompanying text.

carry positions and handle collateral results in the need for robust customer protection requirements. There is no discernible policy rationale for applying different registration tests to such similar products.

In connection with both the CEA and the Exchange Act, the U.S. jurisdictional means test for registration of a non-U.S. CCP is well understood to apply based on the *direct* participation by U.S. persons as clearing members, not *indirect* participation by U.S. persons through correspondent clearing arrangements involving regulated intermediaries.[42] As the SEC has explained, "Correspondent clearing arrangements do not pose the same type of direct risk to the U.S. financial system that foreign [CCPs] with U.S. members pose because customers, unlike [CCP] members, do not take mutual responsibility for the obligations of the [CCP]."[43]

In addition, as previously noted, the CFTC has recognized in other contexts that applying the Dodd-Frank Act's registration requirements extraterritorially to parties transacting with the foreign branches of U.S. bank swap dealers would result in competitive disparities that are not necessary to mitigate risk to the U.S.[44] The SEC has

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42 *See, e.g.*, CFTC Letter No. 87-7 (Nov. 17, 1987) (declining to permit U.S. persons to become direct members of a foreign clearinghouse, but permitting indirect access through omnibus clearing arrangements); *see, also* 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, 78 Fed. Reg. 30,968, 31,039 (May 23, 2013) ("SEC Cross-Border Proposal") (proposal by the SEC that a security-based swap clearing agency register if it has direct U.S. members, but not if it only clears security-based swaps for U.S. persons indirectly through an omnibus (or "correspondent") clearing arrangement).

43 *Id.* Thus, even if Section 2(i) of the CEA was relevant to setting the cross-border scope of the DCO registration requirement for swaps, these *indirect* clearing arrangements would not satisfy Section 2(i)'s requirement for a *direct* U.S. connection or effect.

44 *See* Note 15.

also recognized these considerations.[45] These considerations apply equally in connection with participation in non-U.S. CCPs by the foreign branches of U.S. bank swap dealers. Subjecting a non-U.S. swaps CCP to DCO registration because it permits clearing by the foreign branch of a U.S. bank swap dealer deters non-U.S. CCPs from permitting such clearing. Impeding access to non-U.S. CCPs in this way makes it more difficult for U.S. bank swap dealers to centrally clear their swaps—an incentive directly at odds with the Dodd-Frank Act.

2. Mandatory Clearing Requirement

In addition to requiring a CCP to register with the CFTC as a DCO if the CCP uses U.S. jurisdictional means to clear swaps, the Dodd-Frank Act amended the CEA to mandate central clearing by a registered or exempt DCO of those types or classes of swaps designated by the CFTC.[46] CFTC guidance applies the mandatory clearing requirement extraterritorially to foreign branches of U.S. bank swap dealers (subject to a 5 percent *de minimis* exception for swaps of a U.S. bank swap dealer's foreign branches in jurisdictions other than Australia, Canada, the European Union, Hong Kong, Japan or Switzerland)[47] and, for their swaps with each other[48] or with non-U.S. swap

[45] *See* Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities; Republication, 79 Fed. Reg. 47,278, 47,321 (Aug. 12, 2014).

[46] CEA § 2(h)(1); CFTC Regulations §50.2.

[47] *See* Note 19.

[48] *See* Note 20.

dealers,[49] guaranteed affiliates of U.S. persons.[50] In each of these cases, the CFTC permits substituted compliance with comparable non-U.S. clearing requirements.

As a result, even if a non-U.S. swaps CCP is not, under the DCO registration requirement itself, required to register as a DCO, U.S. firms cannot (absent substituted compliance) use the CCP to satisfy the Dodd-Frank Act's mandatory clearing requirement unless the CCP registers as a DCO or qualifies for an exemption from DCO registration. The Dodd-Frank Act further authorized the CFTC, conditionally or unconditionally, to exempt a DCO from registration if the CFTC determines that the DCO is "subject to comparable, comprehensive supervision and regulation by the [SEC] or the appropriate government authorities in the [DCO's] home country."[51]

3. Bankruptcy Status of Foreign Cleared Swaps

Neither the Dodd-Frank Act's mandatory clearing requirement, nor its authorization for the CFTC to exempt foreign DCOs from registration, contains any limitation on U.S. customers clearing through non-U.S. CCPs that are not subject to, or satisfy an exemption from, DCO registration. Another important consideration, however, is ensuring that U.S. customers clearing swaps through a U.S. FCM at a non-U.S. CCP receive the protections to which customers are normally entitled under the CEA and the Bankruptcy Code (the "Code"). These protections include the provisions

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[49] *See* Note 21.

[50] If they rely on the CFTC's inter-affiliate clearing exemption, conduit affiliates are also subject to the Dodd-Frank Act's mandatory clearing requirement by virtue of the outward-facing swap condition to that exemption. *See* Notes 20 and 21; *see, also* CFTC Regulations § 50.52.

[51] CEA § 5b(h).

of the Code entitling an insolvent FCM's customers to ratable distribution of customer property before that property becomes available to satisfy the claims of the FCM's other creditors.[52] There is some ambiguity as to whether, absent registration of the non-U.S. CCP as a DCO, a U.S. customer clearing swaps through a U.S. FCM at a non-U.S. CCP would be a "customer" under the Code entitled to a priority distribution, in the event such customer's FCM was subject to an insolvency proceeding.

The insolvency of a U.S. FCM is governed by Subchapter IV of Chapter 7 of the Code ("Subchapter IV") and Part 190 of the CFTC's regulations ("Part 190").[53] Subchapter IV and Part 190 afford priority to the "customer" of an insolvent FCM in the distribution of such FCM's "customer property."[54] Whether a person receives such priority depends on the application of several key definitions:

- *Customer Property.* The Code's definition of "customer property" is broad, including items that any applicable law, rule or regulation requires to be set aside or held for the benefit of a "customer."[55]

- *Customer.* The Code defines the term "customer," in turn, to mean, with respect to a U.S. FCM, an "(i) entity for or with whom such [FCM] deals and that holds a claim against such [FCM] on account of a **commodity contract** made, received, acquired, or held by or through such [FCM] in the ordinary course of such

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52 *See* Section 766 of the Code and CFTC Regulations § 190.08.

53 Subchapter IV applies to the insolvency of commodity brokers, a term which includes FCMs.

54 *See* Section 766 of the Code and Part 190.08.

55 *See* Section 761 of the Code.

[FCM]'s business as a [FCM] from or for a **commodity contract** account of such entity; or (ii) entity that holds a claim against such [FCM] arising out of—(I) the making, liquidation, or change in the value of a **commodity contract** of a kind specified in clause (i) of this subparagraph; (II) a deposit or payment of cash, a security, or other property with such [FCM] for the purpose of making or margining such a **commodity contract**; or (III) the making or taking of delivery on such a **commodity contract.**"[56]

- *Commodity Contract.* As described above, the Code's "customer" definition relies on the Code's definition of the term "commodity contract." Prior to the Dodd-Frank Act, the Code defined the term "commodity contract" to include, in relevant part, futures, foreign futures, and any other contract, option, agreement or transaction that is similar to a contract, option, agreement or transaction referred to in the definition.[57] As part of the Dodd-Frank Act, Congress added a prong to the "commodity contract" definition covering any other contract, option, agreement or transaction that is cleared through a clearing organization,[58] which prong the CFTC has read to cover cleared swaps. Yet, Congress did not amend

[56] *See* Section 761 of the Code (emphasis added).

[57] *See* Section 761 of the Code. The definition also contained prongs for leverage transactions, commodity options, combinations of other types of commodity contracts, options on commodity contracts, and certain master agreements and credit enhancements.

[58] *See* Section 724(b) of the Dodd-Frank Act.

the Code's definition of the term "clearing organization," which the Code defines to mean a registered DCO.[59]

The discrepancy between the Code's "clearing organization" definition (which is limited to registered DCOs) and the DCO definition in the CEA (which includes any CCP for swaps, whether registered or not), as well as the absence of a separate prong in the "commodity contract" definition for "foreign cleared swaps" like the prong for "foreign futures," creates uncertainty as to whether swaps cleared through a non-U.S. CCP are commodity contracts under the Code if the CCP does not register as a DCO. If they were not, U.S. customers clearing swaps at such a non-U.S. CCP through U.S. FCMs would not be customers for purposes of such FCMs' bankruptcy proceedings.

Other aspects of the Dodd-Frank Act, however, evidence Congress's intent to treat swaps cleared through non-U.S. CCPs as commodity contracts under the Code. As part of the Dodd-Frank Act's amendments to the Code's definition of "commodity contract," Congress retained the prong covering "any other contract, option, agreement, or transaction that is similar to a contract, option, agreement, or transaction referred to in [the definition]."[60] Given that Congress also (i) added a prong to the Code's "commodity contract" definition covering contracts cleared through registered DCOs and (ii) granted the CFTC the authority to exempt non-U.S. CCPs that are subject to comparable regulation, a swap cleared through such a non-U.S. CCP would appear to

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59 *See* Section 761 of the Code.

60 *See* Section 761 of the Code.

be "similar" to a swap cleared through a registered DCO and, therefore, fall within the Code's definition of "commodity contract."

Not only did the Dodd-Frank Act include amendments to the Code's definition of "commodity contract," it also added a new provision to Section 4d of the CEA (new Section 4d(f)(5)) providing that "[a] swap cleared by or through a [DCO] shall be considered to be a commodity contract as such term is defined in Section 761 of [the Code], with regard to all money, securities, and property of any swaps customer received by a [FCM] or a [DCO] to margin, guarantee, or secure the swap (including money, securities, or property accruing to the customer as the result of the swap)."[61] Such provision, added to the CEA by the same section of the Dodd-Frank Act that amended the Code's definition of "commodity contract," does not distinguish between registered DCOs and exempt DCOs, nor between registered FCMs and exempt FCMs. If the Code's definition of "commodity contract" were interpreted to exclude swaps cleared through exempt DCOs, Section 4d(f)(5) of the CEA would be superfluous and have no effect. Given the canon of statutory interpretation that "a statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or

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[61] *See* Section 724(a) of the Dodd-Frank Act. We note that the heading in the CEA refers to "Cleared Swaps," which are defined as "any swap that is, directly or indirectly, submitted to and cleared by a [DCO] registered with the [CFTC]." CEA §1a(8). However, the operative text does not use the defined term "cleared swap," which is used in other provisions in the CEA, and instead refers to a "swap cleared by or through a [DCO]." It is a canon of statutory interpretation that a heading of a section of a statute should only be used to interpret the statute when the operative text is ambiguous. *See, e.g.*, Fla. Dep't of Revenue v. Piccadilly Cafeterias, Inc., 554 U.S. 33, 47 (2008) ("To be sure, a subchapter heading cannot substitute for the operative text of the statute."); Pa. Dep't of Corr. v. Yeskey, 524 U.S. 206, 212 (1998) ("[T]he title of a statute ... cannot limit the plain meaning of the text. For interpretive purposes, [it is] of use only when [it] shed[s] light on some ambiguous word or phrase." (quoting Bhd. of R.R. Trainmen v. Balt. & Ohio R.R. Co., 331 U.S. 519, 529 (1947))). In this case, the operative text clearly refers to a swap cleared on a DCO and does not require that such DCO be registered with the CFTC. The heading of the section should not be read to change the plain meaning of the operative text.

superfluous, void or insignificant,"[62] the best interpretation of Section 761 of the Code is one that includes in the definition of "commodity contract" swaps cleared through all DCOs, whether registered or exempt.

Interpreting the Code's definition of "commodity contract" to exclude swaps cleared through a non-U.S. CCP would also undermine other provisions added to the CEA by the Dodd-Frank Act. In particular, this interpretation would undercut Congress's express intent to permit U.S. persons to satisfy the Dodd-Frank Act's clearing mandate by clearing swaps through a non-U.S. CCP exempt from DCO registration, by either denying U.S. customers the benefit of that permission or requiring them to forego U.S. customer protections to avail themselves of it.

Thus, even though the Code's definition of commodity contract does not include a prong for foreign cleared swaps akin to its prong for foreign futures, there is a strong basis for the CFTC to interpret the statute to treat swaps cleared through a non-U.S. CCP as commodity contracts.

C. Proposed Approach

Similar to SEF registration (as described in Part I.C. above), the CEA clearly contemplates an approach under which a non-U.S. swaps CCP is subject to DCO registration only if it uses U.S. jurisdictional means to act as a DCO. In addition, U.S. firms cannot (absent substituted compliance) use a non-U.S. CCP to satisfy the Dodd-Frank Act's mandatory clearing requirement unless the CCP registers as a DCO or

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62 Corley v. U.S., 556 U.S. 303, 314 (2009).

qualifies for an exemption from DCO registration. In each case, the CCP would be eligible for an exemption from DCO registration if it is subject to comparable, comprehensive home country supervision and regulation.

1. Use of U.S. Jurisdictional Means

(i) Clearing by U.S. Customers

The non-U.S. swaps CCPs that are currently registered as DCOs all permit clearing by U.S. customers through a U.S. FCM that is a direct member of the CCP. Accordingly, under the U.S. jurisdictional means test for DCO registration described above, each of these CCPs is appropriately subject to DCO registration because they provide direct, un-intermediated access to U.S. FCM clearing members.[63]

This clearing structure is less common in the futures markets because the CFTC has permitted two alternative structures for U.S. customers to clear futures and options contracts listed on an FBOT ("foreign futures and options"): (1) a correspondent clearing structure in which a U.S. customer clears through a U.S. FCM that maintains the U.S. customer's positions and margin in a customer omnibus account held by a non-U.S. clearing member that is not registered as an FCM; and (2) a direct clearing structure in which a U.S. customer clears through a non-U.S. clearing member that is exempt from FCM registration on the basis of comparable home country regulation. The non-U.S. CCP in each of these structures does not admit any direct U.S. clearing

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[63] Two of these CCPs—ICE Clear Europe Limited and LCH Ltd.—also clear futures contracts listed on U.S. DCMs, which is a separate basis for DCO registration. *See* CFTC Regulations § 38.601 (requiring that transactions executed on or through a DCM (other than security futures) be cleared through a CFTC-registered DCO).

members and therefore does not trigger the CEA's DCO registration requirement. In addition, a non-U.S. CCP that clears for an FBOT (as opposed to a U.S. DCM) is not required to register as a DCO so long as it complies with the CPMI-IOSCO Principles for Financial Market Infrastructures (the "PFMIs").[64]

In order to permit these alternative structures, Part 30 includes special disclosure and segregation requirements designed to address the risks and issues presented by U.S. customers interacting with a non-U.S. clearing member that is not registered as an FCM:[65]

- In connection with the correspondent clearing structure:
    - a registered U.S. FCM accepting U.S. customer funds for trading foreign futures or options must provide its customer with a disclosure statement addressing the risks of trading in foreign markets;[66]
    - such a registered FCM is subject to segregation requirements under CFTC Regulations § 30.7 ("Rule 30.7"), which prohibit it from commingling or depositing the funds or other property it segregates to cover its obligations to its customers with respect to foreign

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[64] *See* CFTC Regulations § 48.7(d)(1).

[65] Because a non-U.S. clearing member carrying a U.S. FCM's customer omnibus account does not have any direct contacts with U.S. customers (who instead continue to have a relationship with and be customers of the U.S. FCM), the non-U.S. clearing member is not required to register as an FCM. *See* Rule 30.4; *see, also* CFTC Letter No. 87-7 (Nov. 17, 1987).

[66] CFTC Regulations § 30.6(a).

futures and options (“Rule 30.7 customer funds”) with the FCM’s own assets or with domestic futures customer funds or cleared swaps customer collateral;[67]

- foreign futures and options customers are treated in a separate “account class” from domestic futures customers and cleared swaps customers under the CFTC’s bankruptcy regulations,[68] meaning that domestic futures customers and cleared swaps customers do not share their property with foreign futures and options customers in the FCM’s bankruptcy; and

- in November 2013, the CFTC enhanced this customer protection framework by requiring an FCM to deposit a cushion of its own funds in its Rule 30.7 account,[69] limiting the extent of Rule 30.7 customer funds held outside the U.S.,[70] and requiring an FCM holding Rule 30.7 customer funds outside the U.S. to do so under

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67 Rule 30.7(e). An FCM must maintain its Rule 30.7 customer funds with a bank or trust company located in the U.S., a bank or trust company located outside the U.S. that meets certain capital requirements, another registered FCM, the clearing organization of an FBOT, a member of an FBOT or the designated depositaries of such clearing organization or member. Rule 30.7(b). An FCM must also obtain a written acknowledgement from each depositary as to the status of Rule 30.7 customer funds under the CEA. Rule 30.7(d). Like domestic futures customer funds and cleared swaps customer collateral, an FCM may only invest its Rule 30.7 customer funds in certain specified assets. Rule 30.7(h).

68 CFTC Regulations § 190.01(a)(1).

69 *See* Rule 30.7(f).

70 *See* Rule 30.7(c); *see, also* CFTC Letter No. 14-138 (Nov. 13, 2014).

the laws and regulations of the foreign jurisdiction that provide the greatest degree of protection to such funds.[71]

- Alternatively, in order for a non-U.S. clearing member to carry a foreign futures and options account directly for a U.S. customer without registering as an FCM:
    - the CFTC must first determine that the non-U.S. clearing member is subject to a comparable regulatory regime in its home jurisdiction;[72]
    - once the CFTC makes a comparability determination, a non-U.S. clearing member must take certain additional steps to avail itself of an exemption from FCM registration, including, for example, consenting to U.S. jurisdiction and agreeing to provide the CFTC with access to its books and records;[73] and

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71 Rule 30.7(c).

72 Rule 30.10. In assessing comparability, the CFTC reviews whether the home country regulatory regime includes the following minimum elements: (1) registration, authorization or other form of licensing, fitness review or qualification of persons through which customer orders are solicited and accepted; (2) minimum financial requirements for those persons that accept customer funds; (3) protection of customer funds from misapplication; (4) recordkeeping and reporting requirements; (5) minimum sales practice standards, including disclosure of the risks of futures and options transactions and, in particular, the risk of transactions undertaken outside the jurisdiction of domestic law; (6) compliance audits; and (7) information sharing arrangements. Part 30, Appendix A, Interpretive Statement with Respect to the [CFTC's] Exemptive Authority Under [Rule 30.10].

73 *See, e.g.*, 68 Fed. Reg. 58,583, 58,586-87 (Oct. 10, 2003) (relief for certain U.K.-regulated firms).

- the CFTC does *not* permit an exempt, comparably regulated non-U.S. clearing member to carry a U.S. customer's domestic futures and options positions or collateral.

There would be several benefits to permitting these alternative structures alongside the CFTC's existing framework for U.S. customers to clear swaps at a non-U.S. CCP through a registered FCM clearing member. In particular, Part 30's correspondent clearing structure affords U.S. customers a greater range of FCMs through which they can clear abroad, since the structure does not require U.S. customers to clear through an FCM that is a direct member of every non-U.S. CCP through which the customer wants to transact. At the same time, U.S. customers continue to benefit from the direct protection of the CEA's customer property segregation rules and the Code's customer property distribution rules.

From the perspective of U.S. FCMs, the correspondent clearing structure allows them to offer clearing at a wider range of non-U.S. CCPs—thus expanding the range of business they can conduct—at significantly less cost and risk than direct participation in non-U.S. CCPs. For example, the correspondent clearing structure prevents the need for a registered U.S. FCM to contribute to the guarantee fund of non-U.S. CCPs or become subject to any assessment rights or other extraordinary loss allocation measures pursuant to a non-U.S. CCP's rules and procedures. In addition, the correspondent clearing structure allows U.S. FCMs to more effectively manage risk exposure to CCPs by, for example, consolidating exposure through a single affiliate that need not be an FCM.

To permit U.S. customers to clear swaps using these alternative structures, the CFTC should, similar to its framework for foreign futures and options:

(1) use its authority under CEA Section 4d(f) to adopt appropriate customer protection rules for swaps cleared by a U.S. FCM at a non-U.S. CCP that is not required to register as a DCO or is exempt from such registration, which should be similar to Rule 30.7;

(2) use its authority under CEA Section 4(c) to grant relief from FCM registration for non-U.S. clearing members that are comparably regulated or limit their U.S. activities to carrying FCM omnibus accounts;[74] and

(3) use its authority under CEA Sections 8a(5)[75] and 20(a),[76] as well as Section

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[74] The CFTC staff has previously expressed the view that a U.S. FCM may not maintain a swaps customer omnibus account with a non-U.S. clearing member of a non-U.S. CCP because the non-U.S. clearing member is not permitted to hold the U.S. FCM's swaps customer funds without registering as an FCM itself. *See* CFTC Letter No. 14-41 (Mar. 28, 2014). The CFTC should revise this position or exercise its plenary exemptive authority under Section 4(c) of the CEA to exempt such a non-U.S. clearing member from registration, under appropriate conditions.

[75] Section 8a(5) of the CEA authorizes the CFTC "to make and promulgate such rules and regulations as, in the judgment of the CFTC, are reasonably necessary to effectuate any of the provisions or to accomplish any of the purposes of [the CEA]."

[76] Section 20(a) of the CEA grants the CFTC authority to provide, by rule or regulation, that, among other matters, "certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property [under the Code]." In In re Griffin Trading, a bankruptcy court addressed the scope of the CFTC's authority under this provision. In particular, the court affirmed that Section 20(a) grants CFTC authority to include or exclude "certain" or "specific" property as long as such property originated in or was traceable to a customer's account. An exercise of the CFTC's Section 20(a) authority to include in Part 190's "customer property" definition a customer's swaps cleared at an exempt DCO, as well as associated margin, held in a U.S. FCM's account would be consistent with this reasoning from Griffin Trading. In re Griffin Trading, 245 B.R. 291 (Bankr. N.D. Ill. 2000), vacated as mooted sub. nom., Inskeep v. MeesPierson N.V. (In re Griffin Trading Co.), 270 B.R. 882 (N.D. Ill. 2001). While we note that the bankruptcy court's decision in Griffin Trading was vacated, we nonetheless address the matters discussed in this paper in light of the court's reasoning.

721(b) of the Dodd-Frank Act,[77] to adopt modifications to Part 190:

(a) establishing a separate account class for "foreign cleared swaps," *i.e.*, swaps cleared by a registered FCM at a CCP located outside the U.S. that is not required to register as a DCO or is exempt from such registration; and

(b) making conforming changes to the relevant provisions in Part 190 to effectuate the requirement in CEA Section 4d(f)(5) that a swap cleared by a DCO (whether registered or not) be considered a "commodity contract" under the Code with regard to all money, securities and property of any swaps customer received by an FCM or a DCO (whether registered, exempt from registration or not required to register) to margin, guarantee or secure the swap (including money, securities or property accruing to the customer as a result of the swap).

(ii) Clearing by Foreign Branches of U.S. Bank Swap Dealers

In addition to expanding the range of structures U.S. customers can use to access non-U.S. swaps CCPs, the CFTC should clarify that a non-U.S. swaps CCP does not trigger DCO registration solely because it permits participation (direct or indirect) by foreign branches of U.S. bank swap dealers. Because such participation takes place outside the U.S., it does not involve use of U.S. jurisdictional means by the non-U.S. CCP.

[77] Section 721(b) of the Dodd-Frank Act grants the CFTC authority to adopt rules to define any term included in an amendment to the CEA made by the Dodd-Frank Act.

Moreover, as noted above, the CFTC has recognized in other contexts that applying the Dodd-Frank Act's registration requirements extraterritorially to parties transacting with the foreign branches of U.S. bank swap dealers would result in competitive disparities that are not necessary to mitigate risk to the U.S.[78] It is equally true that subjecting non-U.S. swaps CCPs to DCO registration when they permit participation by foreign branches of U.S. bank swap dealers discourages those CCPs from permitting such participation. To access these CCPs, U.S. banks must incur the costs, including the additional regulatory burden, of subsidiarizing their local clearing operations—a cost that their foreign competitors often do not face. This cost may not be reasonable for a U.S. bank to incur for the sole purpose of accessing a non-U.S. CCP and, therefore, U.S. banks may be foreclosed from accessing foreign markets that require clearing.

On the other hand, comprehensive U.S. regulation of U.S. bank swap dealers by the CFTC and U.S. banking regulators already addresses the risks of foreign branch participation in non-U.S. swaps CCPs. For example, the CFTC's swap dealer risk management regulations specifically address these risks by requiring, among other measures, diligent investigation of a CCP's financial resources and risk management procedures,[79] risk limits[80] and stress tests.[81] Also, prudential capital standards require U.S. banks to assess the regulatory status (including satisfaction of the PFMIs) of all the

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78 *See* Note 15.

79 CFTC Regulations § 23.600(c)(5)(iii).

80 CFTC Regulations §§ 23.609(a)(1), (2) and (3).

81 CFTC Regulations § 23.609(a)(4).

CCPs in which they participate if such banks wish to receive favorable capital treatment.[82] U.S. bank swap dealers are required to report all of their swap transactions, including swaps cleared by their foreign branches through non-U.S. CCPs, in accordance with Part 45 of the CFTC's regulations. The CFTC and U.S. banking regulators can also obtain additional information directly from U.S. bank swap dealers regarding their clearing activity without seeking such information from non-U.S. swaps CCPs. Through these measures, existing regulation already provides the tools for the CFTC and U.S. banking regulators to replicate most of the conditions the CFTC has applied when exempting non-U.S. swaps CCPs from DCO registration.[83]

2. Satisfaction of the Mandatory Clearing Requirement

Regardless of whether or not a non-U.S. swaps CCP triggers the DCO registration requirement by using U.S. jurisdictional means to clear swaps, U.S. firms could not (absent substituted compliance) use that CCP to satisfy the Dodd-Frank Act's mandatory clearing requirement unless the CCP was registered with the CFTC as a DCO or qualified for an exemption from such registration. The risk-focused nature of the CFTC's clearing determination analysis would help ensure that DCO registration or

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[82] *See, e.g.*, definition of "qualifying central counterparty (QCCP)" in 12 C.F.R. § 217.2 and risk-based capital regulations related to cleared swap transactions in 12 C.F.R. §§ 217.35 and 217.133. In order to qualify as a QCCP, a non-U.S. CCP typically must (a) require all parties to contracts cleared by the CCP to be fully collateralized on a daily basis, (b) be in sound financial condition, (c) be subject to effective oversight by a national supervisory authority in its home country, (d) meet or exceed risk management standards established for CCPs under the law of its home country that are consistent with the PFMIs and (e) not have been determined by a U.S. bank regulator to not be a QCCP. 12 C.F.R. § 217.2 (definition of "qualifying central counterparty (QCCP)," paras. (1)(iii) and (2)(iii)). A bank must apply a 100 percent risk weight to exposures to a CCP that is not a QCCP.

[83] *See* Note 35.

an exemption therefrom is not necessary for a non-U.S. CCP whose swaps clearing is not systemically important to the U.S.

For example, even if a U.S. investment fund were clearing swaps through a non-U.S. CCP indirectly through a U.S. FCM carrying a customer omnibus account with a non-U.S. clearing member of the CCP, the fund could not use that CCP to satisfy the Dodd-Frank Act's mandatory clearing requirement unless the CCP were registered with the CFTC as a DCO or qualified for an exemption from such registration. Similarly, if a U.S. bank swap dealer's foreign branch cleared swaps subject to the Dodd-Frank Act's mandatory clearing requirement through a non-U.S. CCP, either the CFTC would need to make a comparability determination permitting the foreign branch to substitute compliance with local clearing requirements, or the CCP would need to register as a DCO or qualify for a DCO registration exemption.

As a result, a non-U.S. CCP clearing swaps with outstanding notional exposures, liquidity, impact on systemic risk and other relevant characteristics that merit a mandatory clearing determination would need to register with the CFTC as a DCO or obtain an exemption from such registration if it wished to attract U.S. open interest in those swaps. This increased level of U.S. regulation for cross-border trading in swaps subject to mandatory clearing would help ensure that, for these commonly traded types of swaps, U.S.-regulated DCOs do not face competition from non-U.S. CCPs lacking comparable regulation.

3. Exemptions for Comparably Regulated CCPs

Qualification for an exemption from DCO registration should depend solely on an outcomes-based analysis of the comparability of a non-U.S. CCP's home country regulatory regime to the CFTC's requirements for DCOs. We support the CFTC's current approach in assessing comparability by primarily looking to whether the relevant home country regulatory regime is consistent with the PFMIs, and we encourage the CFTC to continue this approach.

The CFTC could, however, apply additional conditions to its DCO registration exemptions if the CFTC determined that gaps between home country regulation, on the one hand, and direct CFTC regulation, on the other hand, presented the potential for "direct and significant" risk to the U.S. within the meaning of Section 2(i). Such conditions should be rare, as in most circumstances the CFTC should instead look to enhance the PFMIs (and thus, foreign regulatory regimes) through its participation in IOSCO. Addressing any identified gaps between home country regulation and direct CFTC regulation through the PFMIs serves the added purpose of ensuring globally consistent standards for CCP risk management frameworks. In addition, consistent with Section 2(i), the CFTC's analysis should not only take into account the extent and nature of any regulatory gaps, but also the significance of a non-U.S. CCP's clearing activity to the U.S. financial system.

Where, based on this analysis, the CFTC determines that the CCP's clearing activity satisfies the Section 2(i) standard, it could condition the CCP's exemption from DCO registration. Conditions could include subjecting the CCP to heightened prudential

standards or additional supervisory oversight by the CFTC, in each case, in coordination with local regulators. These conditions should be narrowly tailored to apply solely to the U.S.-related clearing services offered by the CCP, taking into account the fact that most CCPs silo their services by product category and, in some cases, clearing member type. Where appropriate, the CFTC should also work with the Federal Reserve and other members of the Financial Stability Oversight Council to consider what issues may be posed by lack of Federal Reserve Bank discount window access for a CCP that has a significant share of U.S. clearing business and an appropriate way to address any such issues.[84]

On the other hand, conditions that are not justified by Section 2(i) should not apply, such as existing conditions prohibiting U.S. customer clearing through exempt non-U.S. CCPs. The CFTC should instead address the customer protection objective served by those conditions directly through appropriate regulation of the intermediaries through which U.S. customers access exempt non-U.S. CCPs. Limitations or conditions on exemptive relief for non-U.S. CCPs should be solely risk-based.

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FIA and SIFMA believe that the approach laid out above would have several key benefits. Most notably, it would promote the Dodd-Frank Act's pre-trade transparency and systemic risk mitigation objectives and help reverse market fragmentation by expanding the U.S. access to trading venues and CCPs abroad. At the same time, the approach would address customer protection and market integrity objectives by

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84 *See* Treasury Capital Markets Report, at 165.

ensuring that U.S. persons who access non-U.S. swaps trading venues and CCPs abroad are either themselves regulated by the CFTC as swap dealers or are trading and clearing through appropriately regulated intermediaries. The approach would also preserve a level competitive playing field between U.S. and non-U.S. venues and CCPs by limiting direct solicitation of U.S. participation by a non-U.S. venue or CCP and requiring a non-U.S. venue or CCP to satisfy comparable home country regulations (or directly register with the CFTC) if it permitted U.S. firms to trade or clear swaps that are subject to the Dodd-Frank Act's mandatory trading or clearing requirement.

We stand ready to assist further in the development of an approach for U.S. access to non-U.S. swaps trading venues and CCPs that is consistent with the mitigation of risks to the U.S. financial system, the robust protection of U.S. customer property and the mutual recognition of venues and CCPs in the U.S. and abroad. Please contact Jacqueline Mesa of FIA (jmesa@fia.org) or Kyle Brandon of SIFMA (kbrandon@sifma.org) if further information or assistance would be helpful.