ISDA® Safe, Efficient Markets

March 7, 2014

Ms. Melissa D. Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Request for Comment on Application of Commission Regulations to Swaps Between Non-U.S. Swap Dealers and Non-U.S. Counterparties Involving Personnel or Agents of the Non-U.S. Swap Dealers Located in the United States (79 Fed. Reg. 1347)

Dear Ms. Jurgens:

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] appreciates the opportunity to provide the Commodity Futures Trading Commission (the "**Commission**") with comments in response to the request for comment referenced above (the "**Comment Request**"). The subject matter of the Comment Request is Staff Advisory 13-69 (the "**Staff Advisory**"), which sets out the views of the Division of Swap Dealer and Intermediary Oversight ("**DSIO**") regarding the applicability of certain Commission regulations to transactions entered into between a non-U.S. swap dealer, using personnel or agents located in the United States, and a non-U.S. person.

Our comments in this letter are limited to the issues raised by the Commission in the Comment Request and additional items 1-3 set out by Commissioner O'Malia in his separate statement.

Our principal recommendations in this letter are that the Commission:

- not adopt any part of the Staff Advisory as Commission policy, guidance or otherwise (Sections I and VI);

- eliminate personnel-based tests from certain other aspects of its cross-border policy: the "foreign branch" conditions applicable to U.S. swap dealers ("**SDs**"), SEF registration

[1] Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 62 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

criteria and no-action relief made available to EU- regulated multilateral trading facilities (Section I);

- not differentiate in the treatment of swaps between a SD and a non-U.S. counterparty based on the nature of the SD (irrespective of whether the SD is a guaranteed or conduit affiliate of a U.S. person, a foreign branch of a U.S. bank or a non-U.S. person that is neither a guaranteed nor a conduit affiliate), a principle that we apply to the use of personnel-based tests in determining the application of Transaction-Level Requirements and, more generally, to certain other aspects of the Commission's cross-border policy that disrupt non-U.S. markets and impair uniform participation in them (Section II);

- if it decides not to follow our recommendations and implements a personnel-based test for application of Transaction-Level Requirements,

    - formulate any criteria defining "front office" or other triggering conduct though a rulemaking accompanied by public comment and a rigorous cost-benefit analysis or, if it declines to engage in rulemaking, adopt a clear and simple formulation of a personnel-based test (as we propose below) and give due regard to certain practical considerations that we highlight (Section III);

    - make substituted compliance available in each case where Transaction-Level Requirements are triggered by personnel-based tests (Section IV); and

- re-examine the methodology of its comparability determinations for substituted compliance to avoid unhelpful granularity and open the eligibility criteria for an entity to avail itself of substituted compliance to those voluntarily complying with a given jurisdiction's regulation (Section IV).

In Section V, we respond to Commissioner O'Malia's question #2 regarding the Commission's jurisdiction over Covered Transactions with non-U.S. persons and demonstrate that the Commission's views of its extraterritorial jurisdiction disregard the Supreme Court's decision in *Morrison* and are not supported by the lower court holdings cited by the Commission in the Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations[2] ("**July Release**").

I. Inappropriateness of Jurisdictional Tests based on the Location of Personnel or Agents[3]

The Commission should not adopt any part of the Staff Advisory as Commission policy, guidance or otherwise. In the Staff Advisory, the DSIO declared that "a non-U.S. SD (whether an affiliate or not of a U.S. person) regularly using personnel or agents located in the U.S. to arrange, negotiate, or execute a swap with a non-U.S. person generally would be required to comply with the Transaction-Level Requirements." In its Comment Request, the Commission

[2] 78 Fed. Reg. 45292 (July 26, 2013).
[3] This Section I is responsive to Commission Questions 1 and 2 and the first two sentences of Commissioner O'Malia's Question 1.

uses the defined term "Covered Transactions"[4] to restate the position taken in the Staff Advisory and to pose its questions regarding the proper scope of application of transactional requirements. The Staff Advisory and the Commission's "Covered Transaction" definition adopt jurisdictional tests based on the location of personnel or agents of a SD ("personnel-based tests"). ISDA submits that personnel-based tests should not be used to determine the cross-border application of Transaction-Level Requirements.[5]

The location in the United States of personnel involved in specific aspects of a swap transaction between non-U.S. parties does not satisfy the jurisdictional test of section 2(i) or any other jurisdictional provision of the Commodity Exchange Act ("**CEA**"), nor is it relevant as an indicator of the degree of Commission supervisory interest in a particular transaction. The presence in the United States of personnel performing the functions stipulated in the Staff Advisory does not create a "direct and significant connection" or raise evasion concerns, nor does the territorial activity of U.S. personnel coincide with the "focus" (in the sense of the *Morrison* court's analysis, discussed in Section V below) of the statutory provisions that the Staff Advisory seeks to apply to activities outside the United States. Proper supervisory concern over a transaction between non-U.S. persons resides in the jurisdictions of the parties.

Personnel-based tests not only lack statutory basis, they also are unrelated to the Commission's stated justifications for extraterritorial regulation and have undesirable consequences. The "direct and significant" standard of CEA section 2(i) should be interpreted in light of Title VII's primary goal (as acknowledged by the Commission in the July Release) of mitigating the transmission of risks into the U.S. financial system.[6] This concern is absent in Covered Transactions. A non-U.S. SD, by definition, is organized under non-U.S. law and has its principal place of business outside the United States. It will be subject to capital requirements of the Commission, U.S. prudential regulators or a non-U.S. capital regime deemed by the Commission to be comparable and comprehensive. The non-U.S. SD's counterparty in a Covered Transaction is also a non-U.S. person, isolated from the U.S. financial system. Even in those cases where, in the Commission's view, exposure of the U.S. financial system to the non-U.S. counterparty's transactions may be present – namely, where the SD's counterparty is a guaranteed or a conduit affiliate of a U.S. person – the Staff Advisory provides no additional protection because, under the July Release, Transaction-Level Requirements (or comparable and comprehensive non-U.S. requirements) already apply in such circumstances. Thus, the Staff Advisory (and, as we discuss below, the similar personnel-based prong of the "foreign branch"

[4] As defined in the Commission request for comment, "Covered Transactions" are transactions arranged, executed, or negotiated by personnel or agents located in the United States of non-U.S. SDs (whether affiliates or not of a U.S. person) regularly using personnel or agents located in the U.S. to arrange, negotiate, or execute swaps with non-U.S. persons. We note that under the Commission's formulation of Covered Transactions, <u>both</u> (i) use of U.S. personnel to perform the stated functions with respect to a particular transaction <u>and</u> (ii) regularity of involvement of U.S. personnel in transactions with non-U.S. persons must be present in order for Transaction-Level Requirements to be applicable. The Staff Advisory did not have this degree of precision. We assume that the considerations raised in footnote 513 of the July Release, to the extent relevant to transactions of U.S. branches of non-U.S. SDs with non-U.S. counterparties, are parallel to, and now subsumed within, the discussion of the Covered Transactions concept.
[5] The Comment Request uses, without explanation, the term "transactional requirements" rather than "Transaction-Level Requirements", which is the term used in the Staff Advisory and in July Release itself. In this letter, we use the term "Transaction-Level Requirements" to have the meaning given to it in the July Release.
[6] *See* 78 FR 45299 ("a primary purpose of Title VII of the Dodd-Frank Act is to address risk to the U.S. financial system created by interconnections in the swaps market").

conditions set out in the July Release) makes no contribution to what the Commission has described as the primary, risk-mitigating goal of the Commission's cross-border policy.

The Staff Advisory's failure to reflect the true foreign locus of regulatory concern over Covered Transactions is compounded by its denial of substituted compliance. The use of personnel or agents in the United States should not be a factor in the Commission's cross-border regulatory analysis. If, however, the Commission should conclude otherwise, substituted compliance should obviously be made available. See section IV below.

The Commission's regulatory interest in which SD personnel are involved in transacting is limited to ensuring appropriate supervision and control of those personnel. This interest is already addressed by application of the Entity-Level Requirements, which include diligent supervision, a risk management program, conflicts of interest rules and chief compliance officer requirements. The Entity-Level Requirements, or else non-U.S. requirements that the Commission has determined to be comparable and comprehensive, apply to all SDs.

Personnel-based tests have profoundly undesirable practical consequences. They may interfere with an institution's ability to deploy expertise in the most effective manner, potentially increasing institutional risk. For example, if the Commission were to adopt a personnel-based test that lacks sufficient clarity or appropriate exclusions, U.S.-based personnel could be precluded from participating in the structuring and risk management of transactions with a U.S. underlier. Furthermore, personnel-based tests may lead to the relocation of U.S. personnel to other jurisdictions or the reallocation of duties away from U.S. personnel, with a potential cost to U.S. employment. In many instances, non-U.S. counterparties have insisted that the SD's U.S. personnel not be involved in transactions so as not to subject the SD's counterparty to Transaction-Level Requirements.

Permitting front office personnel in different regions, including the United States, to book transactions with non-U.S. persons in a global, non-U.S. swap dealer has significant risk management and liquidity benefits for swap dealers and the global financial system. For example, diversification and netting of exposures in a single legal entity across transactions and counterparties allows for the overall reduction of market and credit risk. As an additional example, consider a G10 options book, which swap dealers are typically required to operate as a global book in a single legal entity given the volatility of the underlying and the fact that there is no "closed" time for G10 FX markets. Non-U.S. clients who actively use these instruments to manage risks are also required to monitor their risk on a 24-hour basis, and they need to have dealer coverage in different regions, depending on the time of day, including during U.S. business hours. Although this example is drawn from the FX markets, regardless of asset class, the risks managed and exposures taken through the swaps market are dynamic throughout the 24-hour day, and clients require support on a 24-hour basis.

There are no plausible competitive concerns or adverse market impacts in allowing U.S.-based personnel of non-U.S. SDs (whether or not affiliated with U.S. persons), or of foreign branches of U.S. SDs, to support dealing with non-U.S. persons. As observed above, these personnel will be bound in their actions by both applicable foreign rules (and, to the extent relevant, by the Commission's generally applicable anti-fraud and anti-manipulation rules, the application of which does not hinge on the criteria for application of Transaction-Level Requirements).[7] Their influence on any U.S. market will be no different regardless of whether they are seated in the United States or in an overseas location.

Finally, there are significant practical limitations with respect to any compliance regime that is predicated on front office conduct as the triggering factor for the application of rules to inherently global transactions. For example, systems configured on the basis of prior Commission positions are not designed to take into account the conduct of individual actors, even if such triggering conduct is appropriately limited and clearly defined. Furthermore, certain Transaction-Level Requirements, such as portfolio reconciliation and margining and segregation for uncleared swaps, are satisfied on a *portfolio* basis, meaning that the inclusion in a portfolio of a single jurisdiction-attracting transaction could require portfolio-wide compliance.

Other Aspects of Cross-Border Policy

The Commission and Commissioner O'Malia ask about the effects of our views regarding the issues raised by the Staff Advisory on other aspects of the Commission's cross-border policy.

For essentially the same reasons as those explained above, personnel-based jurisdictional tests should play no role in other aspects of the Commission's July Release and related staff positions. Accordingly, the Commission should eliminate the location of a U.S. SD's employees who negotiate and agree terms, or manage electronic execution, of a swap as a relevant factor for determining whether a transaction is "with" a foreign branch of a U.S. SD.[8] In the SEF context, personnel-based tests (applied to users of a trading facility) should not be used as criteria for SEF registration of the facility. The DMO Guidance on Application of Certain Commission Regulations to Swap Execution Facilities (November 15, 2013) should be modified to eliminate the provision of access to U.S.-located personnel or agents of non-U.S. persons as a basis for requiring a non-U.S. multilateral trading platform to register as a SEF, and the "U.S.-located person" category should not be employed in other aspects[9] of Commission policy relating to non-U.S. trading facilities. Further, providing trading access to foreign branches of U.S. SDs should not be a basis for SEF registration. Requiring SEF registration solely for this reason fragments liquidity in the global swaps market,[10] damages foreign branch competitiveness, and hinders the ability of U.S. SDs to effectively hedge risks.

The issue of overreach in the Staff Advisory relates to other unduly expansive elements in the Commission's cross-border policy beyond just the use personnel-based tests. For example, and with regard to the appropriate cross-border scope of the SD registration obligation itself, the

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[7] See 78 Fed. Reg. 45337.

[8] 78 Fed. Reg. 45330. Although, unlike the non-U.S. SD case considered in the first part of this section, the risk-bearing legal entity with respect to a foreign branch's swaps *is* a U.S. person, the location of certain personnel within or outside the United States is just as irrelevant to an analysis of U.S. systemic risk as it is in the case of non-U.S. SDs.

[9] We note that Commission staff have employed the "U.S.-located person" category in defining conditions for the eligibility of non-U.S. multilateral trading facilities for the relief provided in CFTC Letter No. 14-16. CFTC Letter 14-16, footnote 44.

[10] See "Cross-Border Fragmentation of Global OTC Derivatives: An Empirical Analysis – ISDA Research Note" (January 2014) and "Footnote 88 and Market Fragmentation – ISDA Research Note" (December 2013) with respect to market fragmentation.

Commission should eliminate the requirement in the July Release that guaranteed or conduit affiliates, despite their status as non-U.S. persons, count all their dealing swaps, including those with other non-U.S. persons, toward the *de minimis* thresholds from SD registration.[11] The same *de minimis* computations should apply to all non-U.S. persons. Introducing a bias toward SD registration of guaranteed or conduit affiliates is not an appropriate regulatory tool to address the postulated "potential to impact the U.S. financial system"[12] (presumably through effects on the US guarantor or the US entities that enter into swaps with the conduit affiliate), nor do these postulated effects have the degree of significance and directness necessary to satisfy the section 2(i) standard.

In addition, use of the conduit affiliate category should be eliminated from all other aspects of the July Release. The treatment of conduit affiliates makes it more difficult and costly for end-users to hedge risk, and the postulated effects within the United States of a conduit affiliate's activities outside the United States do not satisfy the Section 2(i) standard. Further, the indefiniteness of the category (which is defined by listing relevant factors) creates unnecessary compliance uncertainty.

II. There should be no differentiation in the treatment of swaps with non-U.S. counterparties depending on the nature of the SD.[13]

The Commission requested comment on whether there should be any differentiation in treatment of swaps with non-U.S. counterparties depending on the nature of the SD. Commissioner O'Malia poses similar questions.

<u>Use of Personnel-Based Tests to Apply Transaction-Level Requirements</u>

As a general governing principle, ISDA believes that there should be parity of treatment with respect to the application of personnel-based tests when determining whether Transaction-Level Requirements apply to a transaction between a non-U.S. counterparty and a registered SD, irrespective of whether the SD is a guaranteed affiliate or a conduit affiliate of a U.S. person, a foreign branch of a U.S. bank, or a non-U.S. person that is neither a guaranteed nor a conduit affiliate of a U.S. person. Parity should be achieved by rejecting the Staff Advisory's application of personnel-based tests to non-U.S. SDs (whether or not the non-U.S. SD is a guaranteed affiliate or conduit affiliate of a U.S. person) and by eliminating the location of a U.S. SD's employees as a relevant factor for determining whether a transaction is "with" a foreign branch of a U.S. SD, as discussed above. However, if the Commission declines to follow our recommendation and decides to use personnel-based tests to apply Transaction-Level Requirements to Covered Transactions, then, in response to the Commission's and Commissioner O'Malia's questions regarding differential treatment based on the nature of the SD, we see no reason for the Commission to create new distinctions, not present in the July Release, between non-U.S. SDs that are guaranteed or conduit affiliates and non-U.S. SDs that are not. We repeat, as we have explained above: the location of certain SD personnel within or outside of the United States is irrelevant to an analysis of U.S. systemic risk. We do not agree

[11] 78 Fed. Reg. 45318-19.
[12] 78 Fed. Reg. 45319.
[13] This section is responsive to Commission question 3 and the final sentence of Commissioner O'Malia's Questions 1 – 3.

with the Commission's stated justification of the special burdens it has placed on guaranteed and conduit affiliates in other contexts – the justification that these affiliates are meaningful transmitters of risk into the United States. It is clear, however, that this justification has absolutely no relation to personnel-based tests, which in turn have no relation to risk importation into the United States. This disconnect between personnel-based tests and the Commission's justification for its general view of guaranteed and conduit affiliates is another illustration of the lack of reason underlying personnel based tests and of the questionable basis for the Commission's rules relating to such affiliates.

Other Aspects of Cross-Border Policy relating to Distinctions Based on SD Characteristics

The principle of parity of treatment among SDs, appropriately applied, should be extended further in order to mitigate adverse effects of the Commission's cross-border policy on overseas markets. In any market, unless there is uniformity across participants in the rules governing transactions, compliance tractability and ease of transacting suffer. These are important concerns of an SD's clientele outside the United States. The incremental complexity of having to accommodate different regulatory regimes based on the underlying and variable jurisdictional attachments of the SD could dissuade non-U.S. clients from dealing with SDs subject to the Transaction-Level Requirements. Lack of parity among non-U.S. SDs (including guaranteed or conduit affiliates) and foreign branches of U.S. SDs with respect to being able to follow the transaction-level rules of the local jurisdiction introduces transactional frictions and fragments global markets, harming both the ability of U.S. institutions to be competitive abroad and the depth of liquidity available in those markets.

These difficulties could be alleviated by making the Commission's Transaction-Level Requirements inapplicable when a non-U.S. counterparty transacts with a registered SD that is a non-U.S. person (including a guaranteed or conduit affiliate) or with a foreign branch of a U.S. bank that is a registered SD (so long as each SD is subject to or undertakes (to the Commission's satisfaction) to comply with host/local country transaction-level requirements, or those of its counterparty's jurisdiction if the host country regulations would permit such alternative compliance for swap dealers established there). All these cases involve a Commission registrant transacting with a non-U.S. person. That registrant status allows the Commission to exercise its legitimate supervisory role, while deferring to the more compelling supervisory interest of host country regulators with respect to the Transaction-Level Requirements.[14]

Another area of the Commission's cross-border policy where parity of treatment among SDs should be addressed is the test that non-registrants must apply to establish their eligibility for the *de minimis* exemption from SD registration. ISDA submits that swaps that a non-U.S. person

[14] All registered SDs are subject to Entity-Level Requirements, whether under Commission regulations or, in the case of non-U.S. SDs, host country requirements determined by the Commission to be comparable and comprehensive. Entity-Level Requirements address the regulatory interest of protecting the U.S. financial system from risks created in the swap markets through capital adequacy, risk management and swap data reporting requirements, among others. Furthermore, host country regulators have a more compelling supervisory interest in the regulatory objectives served by the Transaction-Level Requirements -- namely, transaction-level risk mitigation, integrity and transparency of local trading markets (a consideration that argues in particular against application of the Commission's trade execution and real-time reporting requirement) and customer protections afforded to non-U.S. counterparties. That the Commission has made external business conduct rules largely inapplicable to non-U.S. counterparties underscores this point.

enters into with registered U.S. swap dealers (whether transacting through a U.S. or a foreign branch and whether or not the SD is a bank) should not be counted for purposes of the *de minimis* threshold. Requiring non-U.S. persons to count such swaps creates a competitive imbalance against U.S. swap dealers and limits the options available to such non-U.S. persons to manage risk, without providing meaningful offsetting benefits. The U.S. SD with whom a non-registrant transacts is already subject to all Entity-Level Requirements, and if the U.S. SD is transacting through its U.S. presence (i.e., the transaction is not "with" a foreign branch), the Transaction-Level Requirements also will apply.

III. The "Covered Transaction" criteria of Staff Advisory 13-69 lack statutory basis and should not be applied to determine extra-territorial application of Title VII rules.[15]

The Commission requested comment on the meaning of "regularly" in the phrase "persons regularly arranging, negotiating, or executing swaps for or on behalf of an SD", the distinguishing characteristics of "core, front-office" and the scope and degree of "arranging, negotiating, or executing" swaps, as such terms are used in the Staff Advisory and the definition of Covered Transactions.

The use of these terms to define the circumstances in which Transaction-Level Requirements should be applied lacks a statutory basis and conflicts with limitations on the Commission's jurisdiction. We do not believe it will be possible to formulate a clear and administrable set of standards for application of Transaction-Level Requirements based on the terms, however they may be defined. In any event, as we point out above, personnel-based tests should not be used to determine the application of Transaction-Level Requirements, and so devising definitions to implement such tests only serves an erroneous goal. Should the Commission nevertheless decide to adopt personnel-based tests, it is crucial that any criteria the Commission formulates be subject to public comment and rigorous cost-benefit analysis as part of a rulemaking and then be applied uniformly to the conduct of U.S. personnel of all SDs, regardless of SD type. Tests that are clear, administrable and free of unintended negative consequences will prove elusive unless they are developed in consultation with a broad range of market participants.[16] In addition, the

[15] This section is responsive to Commission Questions 5 and 6.

[16] Should the Commission nonetheless decide to adopt a personnel-based test without rulemaking and comment, ISDA recommends that the conduct triggering application of the relevant Transaction-Level Requirements be limited to direct communications by SD personnel located in the United States with counterparties, which communications commit the SD to the execution of a particular swap transaction. As an example of the level of detail that must be considered in formulating the elements of a personnel-based test, if regularity of contact by a SD's U.S. branch personnel with non-U.S. persons is used as a jurisdictional criterion (contrary to our recommendation), then the Commission should make allowance for circumstances in which the presence of a non-U.S. person counterparty is not known to the SD at the time of swap execution, such as post-trade allocations and execution on trading platforms that do not exhibit the U.S. person status of the counterparty. As a further example, appropriate exclusions for incidental use of U.S. personnel at the commitment stage of a swap transaction, due for example to execution occurring outside the business hours of the relevant non-U.S. jurisdictions, should be provided.

As Category B Transaction Level Requirements are generally (and appropriately) inapplicable to all non-U.S. SDs and foreign branches of U.S. SDs under the July Release, we assume that the Commission would not now declare any of them applicable through personnel-based tests. To do otherwise would be profoundly disruptive and subject to most, if not all, of the concerns generally raised above. Nonetheless, should the Commission decide to apply Transaction-Level Requirements through personnel-based tests, ISDA recommends that only those Transaction-

Commission should reconsider the Staff Advisory's implication that an overseas booking location is irrelevant to the jurisdictional analysis, as we believe that an analysis based on comity, supervisory interest and risks borne by the U.S. financial system would militate strongly against applying Transaction-Level Requirements to transactions booked in a non-U.S. office of a non-U.S. SD.

IV. Availability of Substituted Compliance with Transaction-Level Requirements for Covered Transactions[17]

For the reasons explained in Section I above, Transaction-Level Requirements should not apply to Covered Transactions. In the event the Commission determines to apply Transaction-Level Requirements, then substituted compliance should be available for all requirements, irrespective of whether the non-U.S. counterparty or the non-U.S. SD is a guaranteed or conduit affiliate of a U.S. person. As explained in Section II above, non-U.S. jurisdictions have the more compelling supervisory interest in the objectives served by the Transaction-Level Requirements when both parties to the transaction are non-U.S. persons. ISDA urges the Commission to re-examine the methodology of its comparability determinations to ensure that it is truly outcomes-based and adequately recognizes the multiplicity of means that other jurisdictions may use to achieve regulatory objectives that are congruent with the Commission's. A substituted compliance regime cannot be effective in alleviating duplicative and inconsistent obligations and market distortions if it applies an unduly granular focus to its comparability determinations.

Further, the Commission should modify the eligibility criteria for an entity to avail itself of substituted compliance with respect to Transaction-Level Requirements once the Commission has made a positive comparability determination with respect to a particular jurisdiction. In its transaction-level comparability determination for the European Union, the Commission appears to condition the availability of substituted compliance on a deemed representation that the scope of the laws and regulations considered in the comparability determination encompasses the "swaps activities" of that entity in the relevant jurisdiction.[18] Furthermore, the Commission states that an entity that is not legally required to comply with a law or regulation determined to be comparable may not voluntarily comply in order to avail itself of substituted compliance.[19] While such eligibility criteria may be appropriate for purposes of substituted compliance with Entity-Level Requirements, they are neither necessary nor appropriate as a condition for substituted compliance with respect to Transaction-Level Requirements. Rather than discouraging voluntary compliance with other jurisdictions' transaction-level regulations, the Commission might encourage both a generally compliant market and the competitiveness of registered SDs in that market by accommodating those who voluntarily comply with comprehensive and comparable regulations. In the event the Commission declines to follow this recommendation, it should at least permit substituted compliance on the basis of comprehensive and comparable regulations that are binding on the SD's counterparty. Transaction-Level Requirements such as clearing, trade execution, portfolio reconciliation and compression, and

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Level Requirements that are transaction-specific and relate to the triggering communication committing the SD to a swap transaction – namely, the portions of Commission Regulations 23.431 and 23.433 that relate to transaction-specific disclosure and communications – should be made applicable.

[17] This section is responsive to Commission Question 4.

[18] 78 Fed. Reg. 78878, 78882 (December 27, 2013).

[19] Id. at 78882 n.32.

swap trading relationship documentation are "bilateral" in the sense that if the requirement applies to one of the parties to a transaction, the other party must also comply in order for the requirement to be satisfied. Therefore, even if the Commission is not comfortable with voluntary compliance, substituted compliance should be made available for such bilateral Transaction-Level Requirements if either the SD or its counterparty is mandatorily subject to the requirement.

V. A Statutory Basis for Commission Jurisdiction over Covered Transactions is Lacking.[20]

CEA section 2(a)(1) in general provides the Commission with limited jurisdiction over "accounts, agreements … and transactions" involving swaps "*except* to the extent otherwise provided in" Dodd-Frank, and CEA section 4b-1 provides Dodd-Frank Title VII specific enforcement authority. But Covered Transactions with non-U.S. persons are fundamentally extraterritorial, and section 2(i), which applies to both of these CEA sections, provides that the Act "shall not apply" to activities outside the United States unless those activities have a "direct and significant connection with activities in, or effect on, commerce of the United States." As a statutory provision that restricts the Commission's jurisdiction, section 2(i) does not stand for the converse proposition that limited conduct by U.S. personnel is a sufficient predicate for Commission jurisdiction. Congress has been clear elsewhere in the CEA when it intended conduct in the United States relating to overseas transactions to be the basis of Commission jurisdiction.[21] No similar intent infuses sections 2(a)(1), 4b-1 or any of the provisions giving rise to Entity-Level Requirements or Transaction-Level Requirements.

This interpretation is consistent with the generally limited view of extraterritorial jurisdiction espoused by the U.S. Supreme Court in *Morrison v. National Australia Bank Limited*,[22] and the specific treatment in that case of activities that took place in the United States. The *Morrison* Court found that alleged deceptive conduct in the United States was insufficient to confer jurisdiction because the "focus" of Section 10(b) of the Securities Exchange Act was on purchases and sales of securities in the United States, not upon the domestic conduct being asserted as the basis for jurisdiction. As the *Morrison* Court stated, "it is a rare case of prohibited extraterritorial jurisdiction that lacks all contact with the United States" and "the presumption against extraterritorial application would be a craven watchdog if it retreated to its kennel whenever some domestic activity is involved in the case."[23] In addition to creating a presumption that silence denotes an intent not to create extraterritorial effect, *Morrison* also provides a rule for interpreting express extraterritoriality provisions. The Court wrote that even "when a statute provides for some extraterritorial application, the presumption against extraterritoriality operates to limit that provision to its terms." 130 S. Ct. at 2883.

The Commission's expansive view of its extraterritorial jurisdiction, as illustrated by the Staff Advisory and as articulated in the July Release, rests on ignoring *Morrison*'s message of restraint and need to avoid conflicts between legal regimes. Far from "limit[ing] [section 2(i)] "to its terms," the Commission, with the intent to broaden its jurisdiction, has mixed and matched lower

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[20] This section is responsive to Commissioner O'Malia's Question 2.
[21] See, e.g., CEA section 4(b)(2), which authorizes the Commission to adopt rules applicable to persons located in the United States who engage in the offer or sale of futures contracts on or subject to the rules of a board of trade located outside the United States.
[22] 130 S.Ct. 2869 (2010).
[23] Id. at 2884.

court holdings in unrelated cases and engages in a divining of Congressional intent[24] of the sort that Morrison rejects.

In fact, even the July Release's analysis of the Foreign Trade Antitrust Improvement Act ("**FTAIA**"), on which the Commission's jurisdictional premise is based, is misguided.

The analysis then mistreats two U.S. circuit court cases, disregarding the one which provides both a narrow reading of the term "direct" and affirmation of the need for "foreseeability" in respect to circumstances underlying alleged liability,[25] and misconstruing the other, which actually requires a reading of "direct" in the section 2(i) context as implicating both foreseeability and substantiality.[26] In other words the case law discussion upon which the July Guidance depends is based on an inaccurate interpretation of FTAIA cases, which interpretation is then inaccurately applied to the words of section 2(i).

This problem of misinterpretation continues beyond the FTAIA when the Commission's analysis seeks even greater expansiveness by reference to "the interconnectedness between firms, traders,

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[24] See, e.g., the discussion in footnote 71, 78 Fed. Reg. 45299-300, of the exchange between Representatives Bachus and Frank regarding a proposed amendment to precursor legislation.

[25] In *LSL Biotechnologies*, the Ninth Circuit held that "applying the *Alcoa* test"—that is, the test that did not use the term "direct," but required both intent to affect domestic commerce and a substantial actual effect—"would render meaningless the word 'direct' in the FTAIA." 379 F.3d 672, 679 (9th Cir. 2004). It cited *Republic of Argentina v. Weltover, Inc.* in giving meaning to the word "direct", a case in which the Supreme Court held that "direct" means that the effect "follows as an immediate consequence of the defendant's activity." *Id.* at 680 (citing 504 U.S. 607, 618 (1992)). After rejecting the *Alcoa* test for failing to treat "direct", the court also noted that that test "might also ignore the words 'reasonably foreseeable'" in the FTAIA, but it hedged, "recogniz[ing] that foreseeability might be a concept inherent in any scheme that seeks to impose liability." *Id.* at 679 n.4. In other words, even though *Alcoa* did not expressly require foreseeability, the Ninth Circuit found it difficult to believe that the Supreme Court intended to leave out such a critical prerequisite to liability – an additional point to note when construing section 2(i)'s "direct and significant" test.

[26] *Minn-Chem, Inc. v. Agrium, Inc.*, ostensibly followed by the Commission in lieu of *LSL*, begins its discussion of this point with an admonition against the presumption that all statutes "use the word 'direct' in the same way." 683 F.3d 845, 857 (7th Cir. 2012). The Commission disregards that cautionary note in reasoning that "the terms included in section 2(i) that are the same as the terms in the FTAIA should be interpreted" consistently, without regard to context. 78 Fed. Reg. 45300, n.74.

That context was central to the Seventh Circuit's interpretation of FTAIA. The court adopted a less stringent reading of the word "direct" in FTAIA only because that statute also included the words "substantial" and "foreseeable." "Congress put th[ose words] there, and in do doing, it signaled that the word 'direct' used along with them had to be interpreted as part of an integrated phrase." 683 F.3d at 857. Reading "direct" to require an "immediate consequence," the court wrote, "results in a stricter test than the complete text of the statute can bear." Id. In other words, the Minn-Chem court was prepared to limit the meaning of "direct" in the FTAIA only because, in that context, the words "substantial" and "foreseeable" accompany "direct."

Nothing in *Minn-Chem* supports reading section 2(i) to authorize regulation of conduct that lacks any foreseeable, substantial, or immediate effect on U.S. commerce. The *Minn-Chem* court understood that "[t]he word 'direct addresses the classic concern about remoteness": "Just as tort law cuts off recovery for those whose injuries are too remote from the cause of an injury, so does the FTAIA exclude from the Sherman Act foreign activities that are too remote from the ultimate effects on U.S. domestic or import commerce." 683 F.3d at 857. The Commission's July Release, by contrast, purports to require "a reasonably proximate causal nexus", 78 Fed. Reg. 45299, while excising the substantiality and foreseeability requirements that lie at the heart of the traditional test for tort liability. *See, e.g.*, *Palsgraf v. Long Island R.R. Co.*, 248 N.Y. 339, 344 (1928) ("The risk reasonably to be perceived defines the duty to be obeyed, and risk imports relation; it is risk to another or to others within the range of apprehension.").

and markets in the U.S. and abroad",[27] underscoring the unbounded nature of its reading of the statutory text. If "a firm's failure, or trading losses overseas, can quickly spill over to the United States and affect activities in U.S. commerce" (*id.*), then it is difficult to imagine any foreign activity that would not have a "direct" effect on U.S. commerce, as the Commission interprets that term.

Those concerns are exacerbated by the Commission's conclusion that swap activities must be "viewed as a class or in the aggregate."[28] That reading rests on a misapprehension of, among others, *Wickard v. Filburn*, a case that "has long been regarded as 'perhaps the most far reaching example of Commerce Clause authority over intrastate activity.'" *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 2588 (2012) (quoting *United States v. Lopez*, 514 U.S. 549, 560 (1995)).

A 70-year-old decision on the Commerce Clause has scant bearing on the scope of the Commission's extraterritorial authority under the CEA. In any event, *Wickard* concluded that an activity may be regulated under the Commerce Clause "irrespective of whether such effect is what might at some earlier time have been defined as 'direct' or 'indirect.'" 317 U.S. 111, 125 (1942). The importation of a standard that explicitly rejects a requirement of directness that section 2(i) explicitly imposes illustrates the perils of cobbling together bits of interpretive guidance from such far-flung sources.

Moreover, even *Wickard* did not hold that a rulemaker may expand its authority by applying classifications that cover both regulable (in the case of 2(i), within the Commission's jurisdiction) and otherwise non-regulable activity (outside the scope of 2(i)). To the contrary, *Wickard* held that local activity may "be reached by Congress if *it* exerts a substantial effect on interstate commerce." 317 U.S. at 125 (emphasis added). *Wickard* permitted aggregation of interstate effects only as to "others similarly situated." *Id.* at 128. The aggregation in that case served only to satisfy the necessary *magnitude* of existing effects no interstate commerce, not to lump together activity that had some effect on interstate commerce with activity that had none. The Commission thus misuses *Wickard* as a source of authority for the proposition that a "direct and significant effect" may be seen in groups of transactions, some of which have no "effect" whatsoever.[29]

Comity problems and conflict with the international harmonization directive of Dodd-Frank section 752, furthermore, inhere in the July Release generally, as evidenced by the oft-expressed concerns of foreign regulators.

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[27] 78 Fed. Reg. 45299.
[28] 78 Fed. Reg. 45300.
[29] Assuming the *Wickard* aggregation rationale applies to section 2(i) at all, therefore, it at least would require the Commission to draw its rules narrowly to ensure that they do not sweep in swaps that have no effects on U.S. commerce at all. The inclusion in the definition of "U.S. person" of non-U.S. companies that have a single U.S. owner that bears unlimited liability, 78 Fed. Reg. 45312, without regard to the capitalization of the non-U.S. company or its U.S. owner, or to whether the company's swap activity threatens either one is just one product of the Commission's jurisdictional overreaching. While there might be *some* foreign companies whose swap trading poses *some* risk to *some* of their U.S. owners, which might engender the contingent possibility of an effect on U.S. commerce, any rules should attempt to isolate such activity with far greater precision.

Our view does not depend on the nature of the non-U.S. SD (i.e., whether it is a guaranteed affiliate or conduit affiliate of a U.S. person).

VI. Distinctions among Transaction-Level Requirements[30]

None of the Transaction-Level Requirements should be applicable to Covered Transactions. As explained in Section II above, non-U.S. jurisdictions have the more compelling supervisory interest in each of the objectives served by the Transaction-Level Requirements.

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Thank you for your consideration of these concerns. Please contact me or ISDA staff if you have any questions.

Sincerely,

Robert Pickel

Cc:

Mr. Mark P. Wetjen
Acting Chairman

Mr. Bart Chilton
Commissioner

Mr. Scott D. O'Malia
Commissioner

Mr. Gary Barnett
Director, Division of Swap Dealer and Intermediary Oversight

[30] This section responds to Commissioner O'Malia's question 3.