May 22, 2013

The Honorable Gary Gensler
Chairman
Commodities Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Chairman Gensler:

We are writing to express our support for the Commodities Futures Trading Commission's (CFTC) proposed rules implementing the cross-border swaps provisions mandated under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). We commend the CFTC for being the global leader in developing a legal framework to oversee this once unregulated market, and for effectively protecting the U.S.-based financial firms, the U.S. financial system, and U.S. taxpayers from future financial crises. Given the interconnected nature of the financial system, we encourage the Commission to exercise this authority consistent with the Commission's Proposed Guidance on Extraterritorial Application of Certain Swaps Rules.

The Federal Reserve provided each of the top 20 financial institutions, including 10 foreign institutions, with more than $120 billion in financial assistance. The unprecedented size and scope of these bailouts was deemed essential in part because modern financial institutions have evolved into integrated and interdependent webs of global affiliates. The four largest U.S. commercial bank derivatives dealers, who account for 93 percent of the $223 trillion of notional value of the U.S. bank derivatives market, have over 3,300 foreign subsidiaries. The sheer size and complexity of these institutions necessitates looking at each firm collectively, and across corporate forms and national boundaries. The activities of subsidiaries, affiliates, branch offices, and off-balance sheet entities may all lead to risk and losses that can devastate a financial institution, and the economy.

While the recent financial crisis demonstrated the devastating effects of the largely unregulated derivatives market, it was not the first crisis in recent history to be driven by derivatives activities conducted through foreign subsidiaries of U.S. institutions. In 1998, a turn in the market drastically reduced the value of esoteric securities held by a Cayman Islands-based subsidiary of the New York-based hedge fund Long Term Capital Management (LTCM). This event nearly caused the fund's collapse, and forced U.S. authorities to help broker a deal to prevent a global market meltdown.

Ten years later, international affiliates again brought risk to the U.S., resulting in the collapse of Lehman Brothers. The firm's complex web of affiliates included Lehman Brothers International (Europe) (LBIE), an unlimited liability company in London with 130,000 outstanding swaps contracts and extensive positions in mortgage securities. Investors realized the firm's assets were tied up in the British bankruptcy process, helping to initiate a run on other U.S. financial institutions with similar foreign affiliates. At the same time, insurance giant American International Group (AIG)'s London-based Financial Products subsidiary wrote $441 billion in credit default swaps that nearly brought down the U.S. financial system. Most recently, the estimated six billion dollar loss by the London unit of J.P. Morgan Chase's Chief Investment Office in the "London Whale" affair provided another reminder of a modern regulatory truth—what occurs abroad will flow back to the Unites States.

A wide range of offshore and cross-border transactions in swaps, including swaps where one of the counterparties is a foreign branch, foreign subsidiary, or foreign affiliate of a U.S. financial institution, have a direct and significant effect on the U.S. economy and financial stability. And because Congress recognized the risks posed to the U.S. from U.S.-based financial institutions' foreign trading, Section 722(d) of the Dodd-Frank Act mandates that swap regulations shall apply to activities outside of the U.S. whenever those activities have a "direct and significant connection with activities in, or effect on commerce" in the U.S. This gives U.S. regulators the authority and obligation to oversee the trading and the institutions involved, irrespective of their physical location.

The CFTC has correctly proposed rules to bring many cross-border transactions that have a direct and significant effect on U.S. commerce under its regulatory authority, including swaps transactions by branches of U.S. institutions offshore, guaranteed affiliates offshore, and hedge funds that are incorporated offshore but operate in the United States. Subject to the concern noted below, we support the CFTC in this initiative, and believe its interpretation is critical to carrying out the full meaning and purpose of Section 722(d). The CFTC's proposed rule should serve as a model framework as other foreign and domestic regulatory authorities develop their cross-border derivatives and swaps regulations.

The United States led the world in enacting derivatives reforms in the wake of the global financial crisis through the Dodd-Frank Act. To date, these reforms represent the strongest protections put in place globally. Recognizing the international nature of the swaps market and the importance of harmonizing international rules, the CFTC introduced the concept of "substituted compliance," which permits sufficiently robust foreign regulatory oversight to fulfill the specific requirements set forth in the Dodd-Frank Act. We commend the CFTC for developing an approach that recognizes equally strong oversight of the swaps market by foreign regulators.

However, the "substituted compliance" determination must be made through a judicious process, on a country-by-country and requirement-by-requirement basis, and subject to a presumption that other jurisdictions do not comply unless proven otherwise. At all times, U.S. regulators must have confidence that the foreign swaps trading operations of a U.S.-based financial institution meet rigorous reporting, record-keeping, clearing, and margin requirements. Those requirements must put the financial institution and its regulators in the same position, and with the same relevant information, as if the foreign swaps trading operations had occurred in the U.S.

In addition, we urge the CFTC, in determining whether to permit substituted compliance, to consider broader financial stability regulations of the jurisdiction being considered. In particular, we believe that it is critical that the jurisdiction have in place a credible resolution authority, which includes a memorandum of understanding with the Federal Deposit Insurance Corporation regarding cooperation on cross-border resolution, for entities engaged in swaps dealing.

We further urge the CFTC, if it elects to accept "substantial compliance" in any form, to review such regulatory regime on a regular basis to ensure that it remains substantively, on a requirement-by-requirement basis, sufficient to mirror the U.S.-based regulatory framework. It is crucial that the CFTC maintains authority over market activity likely to have a direct and significant effect on the U.S. financial system.

As we noted above, we wish to express concern regarding the exclusion from CFTC transactional level requirements, including substituted compliance, of transactions involving a foreign affiliate of a U.S. person where the swaps are not "guaranteed" by a U.S. person. As we saw clearly in the 2008 financial crisis, and in previous crises, even when an activity or vehicle is legally separate from a U.S. person, the U.S. sponsor of that entity or activity steps in, placing the risk back onto U.S. taxpayers. Accordingly, we strongly recommend you extend the requirements of substituted compliance to any transaction where an affiliate of a U.S. financial institution is involved, regardless of where the swap is booked and whether it is guaranteed by the U.S. financial institution or not.

Greater concerns along these lines also exist with respect to the efforts the CFTC should take to reconcile its approach with that of the SEC. The CFTC and SEC rules must not create gaps and loopholes that present arbitrage opportunities, while also maintaining the original intent and reach mandated in Dodd-Frank. Some have pointed out that the SEC—which shares jurisdiction over cross-border swap trading with the CFTC—is taking a "lighter touch" regulatory approach to foreign subsidiaries in its corresponding rulemaking. The SEC's proposed rules are inadequate to fulfill that agency's authority and obligation, and we hope that the SEC will follow the CFTC's model. While we would prefer a system that harmonizes the swap and security-based swap regimes, we urge the CTFC to write the rules it believes are necessary to ensure the stability of the segment of the U.S. financial system under its jurisdiction.

Thank you for the CFTC's work to date implementing Title VII of the Dodd-Frank Act. We encourage you to continue the important and challenging task of overseeing the previously opaque over-the-counter swaps market. Now is not the time to back away from these vital reforms.

Sincerely,

Sherrod Brown
Sherrod Brown
United States Senator

Carl Levin
Carl Levin
United States Senator

Tom Harkin
Tom Harkin
United States Senator

Elizabeth Warren
Elizabeth Warren
United States Senator

Jeffrey A. Merkley
Jeff Merkley
United States Senator

Dianne Feinstein
Dianne Feinstein
United States Senator

Cc: The Honorable Jacob J. Lew
The Honorable Bart Chilton
The Honorable Mark Wetjen
The Honorable Jill Sommers
The Honorable Scott O'Malia
The Honorable Mary Jo White
The Honorable Elisse Walter
The Honorable Luis Aguilar
The Honorable Daniel Gallagher
The Honorable Troy Paredes