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AFR Applauds CFTC for Resisting Continued Wall Street Efforts to Dodge Derivatives Rules

In a brief advisory statement, the Commodity Futures Trading Commission has closed a specious, lobbyist-concocted loophole in the regulation of the derivatives markets. By doing so, the Commission has reaffirmed one of the most important and hard-won victories of the Dodd-Frank Act.

Before the financial crisis of 2008, derivatives had morphed from a hedging tool into the coin of a vast and unregulated global casino. Dodd-Frank put in place comprehensive oversight of these markets, based on transparency and risk management requirements for all derivatives transactions "with a direct and significant connection with activities in, or effect on, commerce in the United States."

That complicated phraseology was there for a reason. In modern financial markets, derivatives can be nominally booked in foreign subsidiaries at the touch of a computer keyboard – even though the risks and profits of these transactions stay with the U.S. parent company, and the transaction itself can be arranged and negotiated on U.S. soil. Wall Street banks routinely book over half their derivatives deals through foreign subsidiaries. The drafters of the law understood that an even greater percentage of transactions could – and would - be shifted overseas if that would enable them to escape regulation.

Wall Street banks, as well as European banks active in the U.S. market, know that their best bet for getting out of new regulations is trying to expand these international loopholes. They have already lobbied this issue hard, but in July of this year the CFTC made clear that there would be limits on what could count as a legitimate international transaction.

Bank lobbyists then seized on an obscure footnote to assert that transactions arranged and negotiated on U.S. soil but booked through a nominally foreign entity could avoid new Dodd-Frank regulation.

In a recent advisory, the CFTC staff firmly rejected this specious argument. The banks' case never had any real credibility. Common sense, the plain language of Dodd-Frank, and even the cited footnote (No. 513 in the CFTC's July advisory) all make it clear that U.S. regulation should apply to derivatives transactions conducted on U.S. soil, wherever they may be booked. Such transactions obviously have a "direct and significant" connection with activities in U.S. commerce.

As CFTC Chair Gary Gensler recently explained, "If a foreign-based swap dealer has personnel in New York and they regularly arrange, negotiate, or execute swaps in the United States, then the transactions come under Dodd-Frank requirements." Such swaps, Gensler went on to say, clearly qualify as what the advisory called the "core, front-office activities" of a swap dealer's business. "In other words, a U.S. swap dealer on the 32nd floor of a New York building and a foreign-based swap dealer on the 31st floor of the same building, have to follow the same rules when arranging, negotiating or executing a swap."

The CFTC has properly interpreted the statute and the guidance passed by the Commission, and has resisted industry pressure to create additional loopholes. We applaud Commission staff for their swift clarification of this vital issue.

Wall Street and its Congressional allies continue to fight back hard. Using overheated rhetoric about an agency "gone rogue," industry lobbyists are attacking the right of CFTC staff to interpret the basic provisions of the Commission's own rules. They are denouncing the Commission for what amounts to a conscientious resolve to carry out the law.