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

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In a brief advisory statement, the Commodity Futures Trading Commission has closed an outlandish, 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 established a system of oversight for these obviously dangerous markets, based on clearing and exchange-trading 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. Even before the crisis, Wall Street banks had booked 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.

Since Dodd-Frank, the CFTC, to its credit, has resisted a series of Wall Street efforts to limit the new rules to transactions conducted entirely within U.S. borders. In July, however, after the CFTC put out a staff advisory restating its position, bank lobbyists seized on an obscure footnote to assert that transactions arranged and negotiated on U.S. soil but booked through a nominally foreign entity could once again be treated as private contracts, and thus not have to follow the new rules.

That is the specious argument that the CFTC staff has now firmly rejected. 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,” Gensler went on, “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 law and rightly resisted industry pressure to create additional loopholes. We applaud the Commission for its swift clarification of this point. In modern financial markets, derivatives can be technically assigned to 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.

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. If a regulatory body is not allowed to define and enforce its own rules free of political interference, nothing in financial regulation will work.