BETTER MARKETS

May 3, 2021

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Notice of Substituted Compliance Application Submitted by the United Kingdom Financial Conduct Authority in Connection With Certain Requirements Applicable to Security-Based Swap Dealers and Major Security-Based Swap Participants Subject to Regulation in the United Kingdom; Proposed Order (Release No. 34–91476; File No. S7–04–21)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned proposal ("Proposal" or "Release") released for public comment by the Securities and Exchange Commission ("SEC" or "Commission").[2] The Commission is proposing an order granting substituted compliance for non-U.S. security-based swap ("SBS") entities, including SBS dealers and SBS major swap participants, that are subject to regulation in the United Kingdom ("UK").

The Financial Conduct Authority ("FCA") of the UK has sought an order from the Commission determining that certain requirements in the UK governing SBS activities are comparable to the SBS requirements under the Securities Exchange Act. The request covered a wide range of requirements, including those relating to risk controls, capital and margin, internal supervision and compliance, counterparty protections, and recordkeeping and reporting. In the Release, the Commission proposes to issue the order, subject to an extensive array of conditions.

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 86 Fed. Reg. 18,378 (Apr. 8, 2021).

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In reality, the UK regime does **not** satisfy the test for an order of substituted compliance. The relevant requirements for SBS dealers in the UK are simply not sufficiently comparable to the U.S. requirements, as evidenced in part by the SEC's own determination that a long list of conditions must be imposed essentially to compensate for the acknowledged gaps in the UK framework. If the SEC is nevertheless inclined to grant the order, it must at a minimum ensure that the conditions set forth in the Release are applied with full force and without exception or dilution. Below, we detail our concerns and we also set forth some general principles that must guide the SEC as it evaluates this request for a substituted compliance order and other requests in the future.

BACKGROUND

The 2007-2009 financial crisis was catastrophic for our financial markets, our economy, and millions of American families. In monetary terms, it destroyed $20 trillion in GDP.[3] And the human toll resulting from millions of home foreclosures, deep and prolonged unemployment and underemployment, and massive loss of wealth is incalculable, and it continues to be felt today. Moreover, on top of the damage caused by the deep recession, as much as $29 trillion was lent, spent, pledged, committed, loaned, guaranteed, and otherwise used or made available to bailout the financial system during the crisis.

One of the key factors that led to and exacerbated the crisis was regulatory arbitrage, both within the United States as between multiple different financial regulatory agencies, and as most relevant here, cross-border. Foreign financial services firms were key actors during the financial crisis, engaging in high-risk activities, suffering existential instability, and ultimately requiring massive bailouts. In fact, fully nine of the top 20 largest users of Federal Reserve emergency lending facilities were foreign entities. Moreover, ten of the top 16 beneficiaries of the AIG bailout, which paid its counterparties 100 cents on the dollar, ten were foreign.[4]

In response to the financial crisis, Congress passed the Dodd-Frank Act, a comprehensive financial reform bill specifically intended to prevent another financial crisis. As relevant here, the Dodd-Frank Act directed the SEC to promulgate rules relating to SBS capital, margin, recordkeeping, and other issues to reduce the possibility and severity of another crisis related to excessive buildup of risk in the swaps markets.[5] The Dodd-Frank Act also included a provision allowing the SEC to establish cross-border rules to prevent evasion of SBS rules.[6]

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3 BETTER MARKETS, THE COST OF CRISIS, $20 TRILLION AND COUNTING (July, 2015), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

4 *The U.S. Bailed Out Foreign Banks in 2008 & Shouldn't Have to Do That Again*, BETTER MARKETS BLOG (Jan. 23, 2014), https://bettermarkets.com/blog/us-bailed-out-foreign-banks-2008-shouldn%E2%80%99t-have-do-again.

5 15 U.S.C. § 78o-10.

6 Substituted compliance is a critically important issue for the reasons explained above, which include the lessons learned from the financial crisis and the clear intent of Congress in passing the Dodd-Frank Act. It takes on added significance in light of the fact that U.S. banks have lobbied to

COMMENTS

I. SUBSTITUTED COMPLIANCE DETERMINATIONS MUST BE MADE ONLY UPON A COMPELLING SHOWING THAT BINDING LEGAL REQUIREMENTS IN FOREIGN JURISDICTIONS ARE COMPARABLE TO U.S. REQUIREMENTS AND WILL PROTECT THE U.S. FINANCIAL SYSTEM

Better Markets continues to have reservations about the "substituted compliance" approach to cross-border regulation taken by the SEC, and in particular its adherence to a "regulatory outcomes" test.[7] However, although the SEC has opted for a suboptimal framework to address cross-border issues, it can, and must, still apply that framework in a manner designed to protect the U.S. financial system which is, after all, the whole purpose of the Dodd-Frank Act. The SEC must do this by carefully examining foreign regulatory requirements to ensure that they protect the U.S. financial system in substance, form, over time, and as enforced. Below we articulate some general principles to guide the SEC as it considers the current application for substituted compliance, as well as others in the future.

A. The SEC's paramount duty under the Dodd-Frank Act is to protect the U.S. financial system

Congress passed the Dodd-Frank Act to, among other things, "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' [and] to protect the American taxpayer by ending bailouts."[8] All of the SEC's actions, including analyzing substituted compliance applications and granting substituted compliance requests, must serve, and not undermine those goals. This is a critical point, because far too often regulators ignore or lose sight of the fact that Congress has explicitly told them to protect the financial system, and they instead prioritize other goals.[9] Not only is this flawed from a policy perspective, but emphasizing other goals, such as reducing costs or burden for the industry,

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be able to book transactions into their "foreign" affiliates and be treated as foreign entities for U.S. regulatory purposes. To the extent that flawed substituted compliance determinations subject foreign entities to less rigorous SBS requirements, the resulting risk to the U.S. financial system is magnified by virtue of this effort by U.S. entities to exploit such weaknesses.

7 *See* Better Markets Comment Letter on Cross-Border SBS at 24-29.

8 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, July 21, 2010, 124 Stat 1376.

9 *See, e.g.,* Remarks of CFTC Chairman J. Christopher Giancarlo to the ABA Derivatives and Futures Section Conference (Jan. 19, 2018) (expressing support for CFTC comparability determinations for the EU, despite differences in rules, because the determination ensures "certainty to market participants and also ensure that our global markets are not stifled by fragmentation, inefficiencies, and higher costs" without mentioning whether the comparability determination would serve to protect the U.S. financial system or serve other stated goals of the Dodd-Frank Act).

while ignoring or minimizing the actual goals Congress directed the SEC to consider, is plainly unlawful.[10]

Put simply, if there is tension between the statutorily-mandated goal of protecting the American financial system on the one hand, and serving some other goal on the other hand, the former wins, period. The SEC simply cannot, as a matter of law or policy, subordinate Congress's will to other goals, no matter how important the SEC's other goals are. Accordingly, before the SEC grants substituted compliance in order to reduce burdens for the industry, provide certainty, or promote international comity, it must first and foremost make a determination that granting substituted compliance promotes the protection of the American financial system.

B. <u>There must be a compelling reason to grant substituted compliance where there are material differences in binding legal requirements.</u>

While the SEC has eschewed a more substantial and precise "requirement-by-requirement"[11] approach to substituted compliance in favor of a broader, ill-defined, and difficult to apply focus on "regulatory outcomes," the reality is that the best way to have confidence that a foreign jurisdiction's regulatory regime will produce substantially equivalent outcomes is to ensure that the relevant jurisdiction has substantially similar binding legal requirements. Simply put, it is difficult to imagine there are many cases where materially different legal requirements produce substantially similar "regulatory outcomes." Nevertheless, if the SEC is going to grant substituted compliance with regard to materially different regulatory requirements, the SEC must make a well-supported, evidence-based determination that those different requirements will, in fact, lead to comparable regulatory outcomes. At a minimum, this would seem to require clearly and specifically articulating the desired regulatory outcome, and providing a fulsome, evidence-based explanation as to how the jurisdiction's different legal requirements nonetheless lead to that regulatory outcome. Speculation and conclusory statements are not sufficient.

Similarly, the SEC should not be in the position of trying to force fit incomparable foreign regulatory requirements to the SEC's "regulatory outcomes" so as to be able to grant substituted compliance. The appropriate question for the SEC to ask is "Would this jurisdiction's regulatory requirements, as they exist, protect the U.S. financial system, and therefore justify granting substituted compliance?" not "What can we do to reconfigure this jurisdiction's regulatory requirements so they meet the threshold for substituted compliance?" Put another way, if the only way to justify granting substituted compliance is to require layer-upon-layer of conditions to ensure that otherwise inadequate regulatory requirements produce comparable regulatory outcomes, then the conditions for substituted compliance have not been met. The SEC has limited resources. It should not be in the position of essentially creating, ad hoc, custom-made rules to supplement inadequate rules of other jurisdictions, all for the benefit of industry participants that want to avail themselves of the benefits of the U.S. financial system without abiding by U.S. regulatory requirements. We note that these are not merely theoretical concerns, as substituted compliance becomes a consideration only once a derivatives dealer has already engaged in

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[10] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) ("Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider")

[11] Release at 18,384.

threshold dealing activities in the U.S. and already poses the types of proximate risks to the U.S. financial system that the SEC itself has determined warrants application of the Dodd-Frank Act.

C. The SEC must ensure that a grant of substituted compliance remains appropriate on an ongoing basis.

A determination that a foreign jurisdiction's SBS rules would produce comparable regulatory outcomes is the beginning, not the end, of the SEC's obligation to ensure that the activities of foreign SBS entities do not pose risks to the U.S. financial system. As time goes on, regulatory requirements that, in theory, are expected to produce one regulatory outcome may, in practice, produce a different one. And, of course, the regulatory requirements may change outright in a variety of ways. Finally, the effectiveness of an authority's supervision and enforcement program can weaken for any number of reasons—the SEC cannot assume that an enforcement program that is presently effective will continue to be effective. Accordingly, to fully fulfill its statutory obligation to protect the U.S. financial system, the SEC must ensure, on an ongoing basis, that each grant of substituted compliance remains appropriate over time. At the very least, this would require that each order granting substituted compliance, and each memorandum of understanding with a foreign regulatory authority, impose an obligation that the applicant, as appropriate:

(1) Periodically apprise the SEC of the activities and results of its supervision and enforcement programs, to ensure that they remain sufficiently robust to deter and address violations of the law; and
(2) To immediately apprise the SEC of any material changes to the regulatory regime, whether explicit (i.e. rule changes) or implicit (i.e. changes in how a rule is interpreted).

II. IT IS INAPPROPRIATE TO RELY ON GUIDANCE AND OTHER INFORMAL OR NONBINDING DOCUMENTS TO SUPPORT A GRANT OF SUBSTITUTED COMPLIANCE

In the Release, the SEC acknowledges a variety of differences between the SEC's SBS rules regarding trade acknowledgement and portfolio reconciliation and the UK's rules.[12] Nevertheless, the SEC proposes to grant substituted compliance for these provisions by additionally relying on "guidance from the European Securities Markets Authority ('ESMA')" which is in the form of a Q&A.[13] As ESMA explains, however "Q&As are not legally binding and only the Court of Justice of the European Union can provide a definitive interpretation of EU law."[14] Moreover, because the UK has, rather famously, left the EU, ESMA and other "non-legislative" EU documents, which are not even legally binding on EU members, do not apply in

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12 Release at 18,383.
13 Release at 18,383.
14 ESMA, Questions & Answers (last accessed Apr. 21, 2021), https://www.esma.europa.eu/questions-and-answers.

the UK at all.[15] Accordingly, the Release cites FCA guidance[16] indicating "that the EU non-legislative materials will remain relevant...to the FCA and market participants in their compliance with regulatory requirements."[17] There are two distinct issues here. First, like the ESMA Q&A, this FCA guidance is not legally binding. Second, the provision cited is extraordinarily vague—it expresses a general consideration and expectation that ESMA's guidance will "remain relevant." In that guidance, the FCA does not commit to ensuring that any particular guidance, including the ESMA Q&A relied on by the SEC, will "remain relevant," nor does it explain what it means for any guidance to "remain relevant," i.e. the FCA does not commit to abiding by the ESMA Q&A.

In other words, the SEC acknowledges that the binding legal requirements in the UK related to trade acknowledgments and portfolio reconciliation are inadequate, and it strives to make up for that inadequacy by reference to a non-legally-binding Q&A document from a jurisdiction, the EU, that the UK does not belong to. And it further relies on another non-legally-binding FCA document indicating, in the most general possible terms, that EU guidance will "remain relevant," without specifying exactly what that means. Finalizing a substituted compliance order that relies on multiple layers of non-binding guidance, one of which is issued by a jurisdiction the UK does not belong to, one of which is so vague as to border on useless, would be an abdication of the SEC's responsibility to protect the U.S. financial system. At a minimum, the SEC must reassess the UK's legal requirements relating to trade acknowledgments and portfolio reconciliation without consideration of the non-binding, inapplicable, and vague Q&A and other guidance documents. If the relevant legal requirements are insufficient on their own to ensure comparable regulatory outcomes (as seems to be the case) to ensure, then substituted compliance is simply not appropriate for those provisions.

III. IF THE SEC IS INCLINDED TO GRANT THE UK REQUEST NOTWITHSTANDING THE DISSIMILARITIES IN THE U.S. AND UK CAPITAL REGIMES, IT MUST AT A MINIMUM CONTINUE TO INSIST ON THE PROPOSED CONDITIONS SET FORTH IN THE RELEASE.

As the Release notes, capital requirements for SBS entities in the UK are markedly different than those ultimately adopted by the SEC for U.S. SBS entities. The SEC opted for a "net liquid assets test" which is intended to ensure that "each dollar of subordinated liabilities is matched by more than a dollar of highly liquid assets."[18] The UK, by contrast, has a capital regime for SBS entities that is based on international standards for banks. As the Release explains, this leads to material differences with the SEC's rules—for example the UK's standards "allows [UK

15 *See* FCA, Brexit: Our Approach to EU Non-Legislative Materials (Oct. 2020), https://www.fca.org.uk/publication/corporate/brexit-our-approach-to-eu-non-legislative-materials.pdf.

16 Release at 18,384.

17 FCA, Brexit: Our Approach to EU Non-Legislative Materials, para. 9 (Oct. 2020), https://www.fca.org.uk/publication/corporate/brexit-our-approach-to-eu-non-legislative-materials.pdf.

18 Release at 18,387.

SBS entities] to count illiquid assets such as real estate and fixtures as capital" and also "allows them to treat unsecured receivables related to activities beyond dealing in security-based swaps as capital notwithstanding the illiquidity of some of these assets."[19] There are other differences. In the UK, initial margin an SBS entity posts to a counterparty counts toward the capital requirements for that entity; in the U.S. initial margin only counts as capital if the SBS entity has a special loan agreement with an affiliate.[20] This latter requirement is intended to mitigate the SBS entity's counterparty credit risk with respect to return of the initial margin. The result is that, not only are the UK's capital requirements different from the SEC's in both form and substance, but the regulatory outcome is not comparable. As the SEC explains in the Release, the UK's different capital requirements means that UK SBS entities "may have less balance sheet liquidity than SBS Entities subject to" the SEC's rules.[21]

The difference between the capital regimes for SBS entities in the UK and U.S. would seem to be a basis for denying the availability of substituted compliance for UK SBS entities. However, instead of simply denying substituted compliance, the SEC proposes to establish a set of conditions that purport to be "designed to ensure the comparability of outcomes in light of the differences between the net liquid assets test and the Basel capital standard."[22] These conditions are the **bare minimum** that the SEC must establish in order to grant substituted compliance for UK SBS entities. The SEC **absolutely must not weaken or eliminate these essential conditions** in response to comments by the industry, which is primarily concerned with reducing its own operational costs, without any regard to the systemic risk that would doing so would pose. Any determination to find the UK's capital requirements comparable to and as comprehensive as the SEC's SBS capital framework **without conditions at least as strong as proposed** would not only contravene the agency's own conception of substituted compliance but expose the U.S. financial system to very risks Dodd-Frank instructed the SEC to contain.[23]

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19 Release at 18,387.

20 Release at 18,387.

21 Release at 18,387.

22 Release at 18,388-89.

23 For similar reasons, the SEC must also not, as suggested in the Release, eliminate or weaken capital conditions if "a Covered Entity's business with U.S. persons falls below a certain notional threshold, such as $8 billion, $20 billion, $50 billion, or some other threshold." Release at 18,408. Creating such a de minimis exemption for foreign SBS entities would be unacceptable. The Release offers absolutely no analysis or justification for why such a threshold for imposition of capital conditions would be appropriate, much less a threshold as high as $8 billion or more. Such an approach would significantly increase risks to the U.S. financial system. It would furthermore set a precedent that other foreign regulators would seek to exploit as they petition for substituted compliance determinations. In any event, it would be inappropriate for the SEC to finalize any sort of *de minimis* threshold solely on the basis of a single question in the Release that contains no supporting analysis. The SEC must, at the very least, propose any such threshold with its own independent, robust analysis for why it might be appropriate, which will allow meaningful informed comment from all stakeholders, rather than just the industry (which will almost certainly enthusiastically support establishment of a *de minimis* threshold with self-serving "analysis.").

Moreover, while Better Markets appreciates that the SEC is proposing the conditions in order to ensure that UK SBS entities relying on substituted compliance do not pose undue risk to the financial system, the mere fact that the SEC, quite rightly, deems such conditions necessary raises the question of why substituted compliance is being granted if no less than five discrete conditions are required to accomplish this goal. Granting substituted compliance with multiple conditions intended to mimic the SEC's capital requirements would seem to undermine the entire point of substituted compliance in the first place protecting the stability of the U.S. financial system by allowing substituted compliance **only when** foreign regimes are comparable.

This approach raises yet further concerns. Essentially, the SEC is layering another set of capital requirements that UK SBS entities will have to abide by, exacerbating complexity and adding to market fragmentation.[24] In addition, the SEC, by essentially crafting a new capital rule ostensibly for the benefit of UK SBS entities, is committing to the assumption of additional regulatory burdens; as the Release acknowledges, the SEC will have to "monitor their impact on firms and to make adjustments as appropriate."[25] This in turn raises the concern that, having granted substituted compliance for these capital requirements, if the SEC's monitoring finds that the conditions increase burdens and costs for impacted firms (as seems inevitable), the SEC will drop the conditions rather than rescinding the grant of substituted compliance. In order to avoid this, the SEC should strongly consider simply denying substituted compliance for capital requirements on the basis that the UK's capital requirements do not produce comparable regulatory outcomes. The burden would then fall on the UK, as it should, to raise its standards governing SBS activities, so that the requirements and outcomes under its regime are truly comparable to those produced under U.S. law.

CONCLUSION

We hope you find these comments helpful.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen Hall

24 Needless to say, if the SEC grants substituted compliance on the UK's capital requirements, it must not weaken these conditions.

25 Release at 18,389.

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