August 27, 2012

Mr. David A. Stawick
Secretary Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington DC 20581

Re: Proposed Interpretive Guidance and Policy Statement: Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act (RIN 3038-AD57)

Dear Mr. Stawick:

Better Markets Inc.[1] appreciates the opportunity to comment on the above-captioned proposed interpretive guidance and policy statement regarding compliance with certain swap regulations ("Proposed Interpretive Guidance", "Proposed Guidance"), issued by the Commodity Futures Trading Commission ("CFTC", "Commission").

**INTRODUCTION**

This Proposed Interpretive Guidance is of overwhelming importance to the U.S. taxpayer, financial system, and economy. If done incorrectly, it will put taxpayers at grave and increased risk of having to bail out Wall Street and the global financial system again and probably pretty soon. Given the enormous and ongoing costs inflicted on the American people from the most recent financial collapse and economic crisis, this would be an egregious mistake of historic proportions and it would violate the Dodd-Frank financial reform and Wall Street re-regulation law.

If CFTC regulations only applied to financial operations in the U.S., firms would simply move their operations overseas where there is less regulation and, therefore, less regulatory costs. In fact, they would argue – correctly – that U.S. law incentivizes them to do so. That would be fine, if the risks to the U.S. financial system, economy, and taxpayers vanished when those operations move overseas, but they do not.

In fact, such a regulatory and legal regime would be the worst of all worlds: the operations go overseas, the revenue goes overseas, and even the jobs go overseas, but the risks from those operations stay in the U.S. and the bill for the financial wreckage created when the risks of those overseas operations materialize is handed to the U.S. taxpayer, which gets none of the upside and all of the downside.

1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

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It's actually worse: because those financial firms move overseas to get the "benefit" of less regulation and the likelihood of those risks materializing actually increases when they move overseas. Therefore, the odds that another collapse and crisis happen increase as does the risk to U.S. taxpayers and likelihood of yet more bailouts for Wall Street.

That is and should be totally unacceptable to everyone, other than those in the financial industry who can increase their profits by moving their operations overseas where there is less regulation and supervision. But **less regulation** and supervision **of** Wall Street's operations wherever they happen means **less protection** for the American taxpayer, financial system, and economy **from** Wall Street's reckless trading and investment activities.

That is why Congress passed the Dodd-Frank financial reform and Wall Street re-regulation law: to protect the American taxpayer from ever having to pay for another Wall Street bailout. The 2008 near-collapse of the United States financial system and the economic crisis that it precipitated was in no small part triggered and magnified by the overseas operations of U.S. firms and the activities of firms headquartered outside of the U.S. Congress explicitly noted this in the Dodd Frank law, which authorized the CFTC to regulate certain overseas activities. Importantly, Congress expressly limited that overseas regulation to only activities and transactions that have a "direct and significant effect" on U.S. Commerce.

By issuing the Proposed Interpretive Guidance, the CFTC has taken a crucial first step toward clarifying how it intends to apply the terms of the statute to overseas transactions and entities. However, the Proposed Guidance must be significantly strengthened if it is to fully protect the interests of the U.S. taxpayer, as it must according to the dictates of both the law and good policy.

## <u>SUMMARY OF COMMENTS</u>

*A. Comity and Statutory Interpretation*

Principles of international comity are relevant to the U.S.'s application of U.S. law beyond the U.S. borders. However, the Proposed Guidance both overemphasizes and decontextualizes their relevance. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act", "Dodd-Frank law") is constructed in such a way that comity is already considered and written into the law, principally in limiting the application of U.S. to only those circumstances where such non-U.S. activity has a "direct and significant…effect on U.S. commerce." The CFTC must therefore focus on its task of protecting the U.S. taxpayer by enforcing the Dodd-Frank law provisions on swaps regulations.

*B. U.S. Person Definition*

The Proposed Guidance mistakenly distinguishes between branches and guaranteed subsidiaries, and between guaranteed and non-guaranteed subsidiaries. This is based on an analysis that is inappropriate to the context of swaps regulations that are intended to protect against a future crisis. In situations of market stress, and often even in normal market conditions, subsidiaries without an explicit guarantee pose just as much of a threat to the stability of the parent company, which must bail them out or risk losing all credibility in the marketplace. Thus, the definition of U.S. person must be extended to all subsidiaries of a U.S. person, whether guaranteed or not.

*C. Appropriateness of Substituted Compliance*

Substituted compliance is in no case appropriate for U.S. persons, even those housed overseas. It is only appropriate for non-U.S. persons that fall under the CFTC's jurisdiction via the "direct and significant" test.

*D. Guidelines for Substituted Compliance*

Insofar as substituted compliance is permitted, it must adhere to four key principles: (1) case-by-case analysis, (2) equivalence in form, substance, and over time, (3) a demonstrable track record of strict enforcement, and (4) a duty for those invoking substituted compliance to report in a timely manner any changes in the regulations or qualifications that originally underlay the allowance of substituted compliance.

*E. Section 15(a) Economic Factor Consideration*

The law does not require the CFTC to consider the economic facts in Section 15(a) of the CEA with respect to the Proposed Interpretive Guidance for cross-border application of swaps regulations. Moreover, even when Section 15(a) does apply to rulemakings, there is no support for the biased, misleading and incomplete version that the industry claims the CFTC must do.

## DISCUSSION

*A. Comity and Statutory Interpretation*

*The Dodd-Frank Act confers both the legal authority and the duty for the CFTC to protect the interests of the American people by enforcing the swaps provisions in the Dodd-Frank Act in **any** scenario where an entity or transaction has a "direct and significant…effect on U.S. commerce."*

This includes but is not limited to all swaps transactions and entities transacting swaps with the potential to precipitate another global financial crisis. As the Proposed Guidance notes, this does not mean that every swap transaction in the world should be regulated by the CFTC, but it **does** necessarily entail a broad scope of jurisdiction.

Specifically, the CFTC must recognize that a core principle of its mandate is to protect the American taxpayer from being at risk of having to pay for another bailout of the financial industry. Principles of international comity are, of course, relevant, and must be taken into account, but regulators have to be mindful that many objections are little more than pretexts to limit or weaken the provisions of the Dodd-Frank law regarding cross-border application of swaps regulations. Moreover, the Commission must recognize, while foreign sovereigns continue to work at passing new financial reform legislation, their regulatory systems remain out of date. Any analysis of comity considerations must bear this in mind. While it is plausible that equivalent financial reform legislation with respect to derivatives will at some future time be passed overseas, at present it simply is not in place. Therefore, the need for American taxpayers to be protected now is clear.

The fact remains that financial activities overseas were central to the financial crisis in 2008 that almost caused the collapse of the U.S. and global financial system. AIG is the best-known example: its un-capitalized credit default swap ("CDS") business was run out of London, but the $182.5 billion bill for its collapse was handed to the American taxpayer.[2] Four years later, the U.S. government is still the largest shareholder of AIG, owning 53 percent of its stock.

But, AIG was by no means an isolated event. Less well known, but equally important, it has also been revealed that over half of the AIG bailout funds eventually made their way to foreign banks.[3] Furthermore, a GAO report determined that trillions of dollars of near zero-rate loans were made by the Federal Reserve to foreign banks.[4] And it has been widely publicized that the single biggest borrower from the Federal Reserve's discount window at the height of the crisis in late October 2008 was Dexia, a Belgian bank.[5] These examples also make it clear that the threat is not limited to foreign subsidiaries or affiliates of U.S. companies.

These near-collapses and bailouts and other evidence from the crisis of 2008 make it abundantly clear that U.S. corporate operations overseas and foreign financial institutions with a *"**direct and significant…effect on U.S. commerce**"* pose an immediate and substantial threat to the stability of the U.S. financial system and economy.

Of course, there have been more recent examples of foreign affiliates of United States firms creating problems for their parent companies. The ongoing JP Morgan Chase "London Whale" scandal underscores the risks that overseas affiliates can generate for U.S.-based companies, even those ostensibly well run and allegedly with superior internal and financial controls. In this case, the London-based Chief Investment Office placed a proprietary bet of more than $100 billion, which has generated losses so far of nearly $6 billion for its U.S. parent bank.[6]

JP Morgan Chase has also disclosed that those losses could increase by billions more. While this particular loss apparently can be managed by JP Morgan Chase without the need for bailouts or creating systemic risk, that should not provide much comfort: this loss could have been much, much greater and, given the massive and total breakdown of management, financial, and compliance controls, there's no reason to believe a much bigger – and potentially destabilizing – loss may not surprise everyone again. And that says nothing about all the other banks and financial institutions, which don't have state-of-the-art management and controls.

For all these reasons, the CFTC must focus now on creating a safe and transparent cross-border derivatives regime. If and when foreign jurisdictions catch up with the necessary standards, that would be the time to consider modifying the rules. However, a cautious approach to cross-border enforcement at a time when no such foreign law is in place, and when overseas affiliates and foreign firms are unmistakably creating risks for U.S. commerce,

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2 *See* GAO, Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance GAO-11-696, Jul 21, 2011 available at http://www.gao.gov/products/GAO-11-696.

3 http://www.businessweek.com/the_thread/economicsunbound/archives/2009/03/german_and_fren.html.

4 GAO, op. cit.

5 http://www.bloomberg.com/news/2011-03-31/belgium-s-dexia-drew-most-from-discount-window-during-record-week-in-2008.html.

6 *See* http://articles.chicagotribune.com/2012-08-23/business/sns-rt-us-jpmorgan-loss-whalebre87m0wg-20120823_1_bruno-iksil-javier-martin-artajo-ina-drew.

would be irresponsible and against the legal mandate to the CFTC to act to protect not just U.S. taxpayers, but also the financial system.

*Comity does not trump the legal mandate for the CFTC to protect the American taxpayer from being put at risk of having to fund another global bailout.*

The Proposed Guidance sets out various case histories to support the notion that comity requires a narrow interpretation of the cross-border provisions of the Dodd-Frank Act. However, these case histories do not appear to be applicable. For example, the Proposed Guidance focuses on antitrust cases.[7] This appears *prima facie* reasonable because the relevant statute, the Federal Trade Improvement Antitrust Act ("FTAIA") of 1982, contains a similar – though not identical – cross-border "effect" provision to that of the Dodd-Frank Act. In the former case, FTAIA stipulates that U.S. antitrust law only applies to foreign activities if such conduct has a "direct, substantial, and reasonably foreseeable effect" on the U.S. market. But, it also has another key limitation not in the Dodd-Frank law, requiring that "such effect gives rise to a claim under the provisions of [the longstanding antitrust law known as the Sherman Act]". The Dodd-Frank law does not have any such limitation, undoubtedly because waiting for a violation of a specific law would likely result in systemic risks building, unseen and unregulated.

The CFTC appears to draw the wrong lesson from the FTAIA story. The key point of the Supreme Court's decision and published opinions is clearly not that United States regulatory agencies and courts have no jurisdiction over transactions that take place overseas. Rather, it is that they have no jurisdiction over transactions that take place overseas **and** have no effect on U.S. markets **and** do not violate a specific statute.

Much more importantly, those histories do not relate to the foreign application of U.S. laws that arise from a massively damaging event on the scale of the near collapse of the financial system and an economic crisis. The financial crisis was the worst since the Crash of 1929 and the American people are suffering through the worst economy since the Great Depression. Indeed, the country just barely avoided suffering from a second Great Depression.

That is why the Dodd-Frank law was passed and it is intended to not only prevent that from happening again, but to also prevent worse from happening, like a second Great Depression. Key to accomplishing that is uniformly regulating those activities and firms that create those risks, whether that is within the U.S. or outside the U.S. That is why cross-border regulation is absolutely critical, either directly or by appropriate substituted compliance (discussed further below).

Finally, the fact that the Dodd-Frank Act contains an explicit "direct and significant" test demonstrates that it was written with comity in mind. Comity is a country giving proper deference to activities in another country, which was done here by limiting the scope of the law to only where an entity or transaction has a **"direct and significant…effect on U.S. commerce."** In addition to that, allowing for substituted compliance, when appropriate, shows even greater deference. Thus, the law was written **with comity considerations already incorporated,** rather than leaving such deliberations to the CFTC's discretion. In

[7] Federal Register 77 134 ("Release") at 41223

short, the CFTC is charged with overseeing all swaps transactions and entities engaged in swaps transactions that have a direct and significant effect on the United States markets. As is discussed below, this includes a far broader group than the Proposed Guidance countenances.

Naturally, U.S. regulators should coordinate closely with foreign regulators. A good idea is a good idea, regardless of its place of origin. Thus, insofar as foreign regulators establish best practices for market oversight, the CFTC should consider adopting their approach, if it would be appropriate to do so. However, to the extent that foreign sovereigns lag behind the United States in the pace of their financial reform or robustness of their financial regulations, the CFTC is legally obligated to act.

*B. U.S. Person Definition*

*The legal concept of a "U.S. person" for the purpose of applying swaps regulation* ***must*** *include any subsidiary of an entity that is headquartered, incorporated, or otherwise controlled in the United States, regardless of whether it is wholly or partially owned, and regardless of whether or not there are explicit financial guarantees in place from the parent company.*

The distinctions drawn between subsidiaries and branches and between guaranteed subsidiaries and non-guaranteed subsidiaries in the Proposed Guidance are flawed.[8] In the first instance, the difference between a branch and a fully guaranteed subsidiary is of no practical significance; some firms operate through the former, others through the latter.[9] In both cases, the final counterparties consider themselves to be dealing with the parent company; without the implicit or explicit guarantee of the parent, the client-facing entity would be considered entirely unsuitable.

Indeed, the CFTC has appropriately recognized this point elsewhere, in its final rule on Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (RIN 3235-AK65):

> "When a swap counterparty typically provides a guarantee as credit support for its swap obligations, the market will not trade with that counterparty at the same price, on the same terms, or at all without the guarantee. The guarantor's resources are added to the analysis of the swap; if the guarantor is financially more capable than the swap counterparty, the analysis of the swap becomes more dependent on the creditworthiness of the guarantor."[10]

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8 Release at 41220

9 For instance, Goldman Sachs is well known to make use of wholly owned subsidiaries. "Goldman Sachs Execution & Clearing, L.P. (GSEC), a limited partnership, registered as a U.S. broker dealer and futures commission merchant, together with its consolidated subsidiaries (collectively, the Company), is a wholly owned subsidiary of SLK LLC, a limited liability company. SLK LLC is a wholly owned subsidiary of Goldman Sachs Trade Management LLC, which is a wholly owned subsidiary of The Goldman Sachs Group, Inc. (Group Inc.), a Delaware Corporation." http://www.goldmansachs.com/investor-relations/financials/archived/gsec-financial-condition/gsec-financial-condition-5-30-08.pdf In contrast, JP Morgan is more generally associated with branches (*see*, e.g. http://www.jpmorgan.com/cm/cs?pagename=JPM_redesign/JPM_Content_C/Generic_Detail_Page_Template&cid=1309472651179&c=JPM_Content_C). Counterparties do not differentiate between a branch and a wholly owned, fully guaranteed subsidiary.

10 CFTC Final Rule on Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (RIN 3235-AK65), at 68.

As the above passage clearly recognizes, when a guarantor stands behind a transaction, the customer's creditworthiness analysis shifts to the guarantor rather than the counterparty. In other words, they ultimately consider themselves to be transacting with the guarantor. Thus, the Proposed Guidance should be revised to abandon the distinction between branches and guaranteed subsidiaries.[11]

Crucially, however, within the context of cross-border application of swaps regulation, it is not enough to stop at the level of guaranteed subsidiaries. This is because even though counterparties will regard a guaranteed subsidiary differently from a non-guaranteed subsidiary, **both pose a significant risk of contagion to the parent company in times of market stress.**

Even when a subsidiary lacks an explicit guarantee, it almost certainly possesses an implicit guarantee – not on a transaction-by-transaction basis (hence why counterparties rightly regard a guaranteed subsidiary as a safer bet) – but certainly on a portfolio level. This is because reputationally, a dealer or large trader in the swaps market simply cannot afford to allow a supposedly non-guaranteed subsidiary to fail, except in very marginal cases.

As all swap market participants can confirm, a parent's or sponsoring company's "choice" to let a subsidiary fail will inevitably be interpreted as a sign of balance sheet weakness or as a breach of a claimed prior understanding, practice, or expectation. As a result, any substantial market participant making such a decision will inevitably see a decline in business and order flow, likely precipitously and in very large amounts. In the most extreme case, a failure to bail out a subsidiary can trigger a crisis of market and counterparty confidence, causing a sudden liquidity squeeze, precisely the conditions that caused the near collapse of the financial system post-Lehman bankruptcy.

Indeed, the last financial crisis proved definitively that even non-guaranteed subsidiaries are bailed out when under stress, bringing the risks and liabilities back to the U.S. financial system and proving that cross-border regulation must be applied to them.

Citigroup's structured investment vehicles ("SIVs") were just one high profile example of non-guaranteed subsidiaries that were eventually bailed out by the parent.[12] As documented in Better Markets' Volcker Rule comment letter, Citigroup engaged in extensive proprietary trading in the run-up to the crisis, which ultimately precipitated its near downfall. Much of this proprietary trading took place through either guaranteed conduits or non-guaranteed SIVs. In 2007, to avoid failure of its guaranteed conduits, Citigroup bought $25 billion of commercial paper that had been issued by its Super Senior conduits and placed those Super Senior securities on the books of the Citigroup commercial bank.[13] Citigroup also "chose" to bring $49 billion of SIV assets onto its balance sheet, even though it had no legal obligation to do so, since no guarantee was in place.[14] No distinction was made between the

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11 Release at 41221

12 Better Markets comment letter to FSOC on Supervision of Large Nonbank Financial Companies, on 7, *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2011-0001-0082.

13 Better Markets comment letter to CFTC on Volcker Rule, on 15, *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=57403&SearchText=.

14 Citigroup Inc. 2007 10-K, 163 *See* www.marketwatch.com/story/citigroup-to-take-49-bln-of-siv-assets-onto-balance-sheet.

guaranteed subsidiaries and the non-guaranteed subsidiaries: Citigroup knew that to allow either to fail would have been corporate suicide.

Beginning in November 2007, Citigroup was forced to recognize huge losses on the Super Senior securities and other positions.[15] By the end of 2008 Citigroup had written off $38.8 billion related to these positions and to asset-backed securities and CDO securities it held in anticipation of constructing additional CDOs, as well as extensive losses on the positions it absorbed from SIVs.[16]

These losses dramatically reduced Citigroup's capital, helped to bring the company to the brink of failure, and requiring hundreds of billions of dollars in bailouts. The amount of federal help required to prevent Citigroup from failing was breathtaking, including capital injections, debt guarantees, and asset guarantees.[17]

Other transnational banks – including Barclays, HSBC, Dresdner, and Bank of Montreal – also moved SIV assets onto their balance sheets to avoid reputational damage.[18]

This clearly illustrates why there should be **no distinction** drawn in applying swaps regulations cross-border between guaranteed and non-guaranteed subsidiaries of a U.S. person: both types of subsidiary have a proven track record of causing life-threatening losses to the parent company, so both must be regulated as U.S. persons due to the immediate threat they can pose to U.S. commerce in stressed situations. Both must be bailed out to avoid a complete loss of market and counterparty confidence, and both are therefore capable of generating huge, systemically significant losses for the parent company.

This is so even if the subsidiaries in question are individually small, since as a group they can add up to significant losses. Among all the ABCP conduits rated by Moody's as of January 1, 2007, the mean asset size was only $4.1 billion. However, collectively these entities accounted for $1.2 trillion, an amount that was more than sufficient to do fatal damage to the balance sheets of the largest banks when significant losses occurred within those SIVs and conduits.[19]

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15 Citigroup, Inc. (2007). Press release, November 4 (announcing losses of approximately $8 billion to $10 billion), *available at* http://www.sec.gov/Archives/edgar/data/831001/000110465907079495/a07-28417_1ex99d1.htm.

16 *See* Citigroup, Inc., Form 10K for the period ending December 31, 2007, 48; Form 10K for the period ending December 31, 2008, 68.

17 *See* Special Inspector General for the Troubled Asset Relief Program (2011). Extraordinary Financial Assistance Provided to Citigroup, Inc., January 13.

18 W. Bratton and A. Levitin (2012). A Transactional Genealogy of Scandal: From Michael Miliken to Enron to Goldman Sachs, University of Pennsylvania Law School Research Paper No. 12-26, 55-56, *available at* http://ssrn.com/abstract=2126778.

19 V. Acharya et al. (2011), p3.

This begs the question whether **any** subsidiary of a U.S. person may escape classification as a U.S. person for the purpose of cross-border application of swaps regulation. Several principles suggest themselves as an appropriate gauge:

- First, if a foreign affiliate incorporates the parent's name in its own, the inference of support is both real and deliberate.

- Second, to be truly divorced from the parent, a foreign subsidiary would have to include in all trade documentation an explicit statement that the parent will NOT provide resources, of any type or form however labeled, directly or indirectly to the subsidiary, accompanied by an explicit waiver by the counterparty of any claim against the parent.

- Third, the CFTC should consider requiring a public filing by the parent with the CFTC committing that it will not provide such resources to the subsidiary under any circumstances, thereby triggering the Dodd-Frank Act's "false statements" provision if the parent does in fact intercede in any way.[20]

In addition to the ideas suggested here, the CFTC should consider other supplemental approaches. As was argued above in Section A, the CFTC would do well to look to the good ideas of overseas regulatory regimes. One such idea from the United Kingdom may be relevant in this case. The recent Vickers Report explored the concept of a “ring-fence” system to insulate depository institutions from trading operations. In the UK’s approach, retail banking must be clearly separated from investment banking, though common ownership is permitted. Within a banking corporation, retail operations must be established as separate legal entities from investment banking operations. All assets must be earmarked for one group or the other, with no possibility of asset transfer between subsidiary and parent. Assets that are on the balance sheet of the subsidiary cannot be taken onto the books of the parent, and vice versa.[21]

The same approach could plausibly be applied to the question of which subsidiaries of a U.S. person should be considered also a U.S. person. Clearly, given the reputational impact of allowing a subsidiary to fail – regardless of guarantee – there is an inevitable contagion effect from subsidiary to parent, unless there is a strict, publicly disclosed and executive certified prohibition on asset transfer between the two. Thus, if any subsidiary of a U.S. person is to escape designation as a U.S. person itself, some sort of ring-fence-like separation is an absolutely necessary condition. The CFTC should consider whether foreign subsidiaries clearly ring-fenced in the manner described above should be excluded from U.S. person designation.

If a subsidiary or affiliate is ring-fenced, the CFTC should require that the CEO or equivalent officer of the parent company notify the Commission and shareholders in writing whenever resources of the parent are used, directly or indirectly, to cover any obligation of a ring-fenced subsidiary. Failure to notify the Commission should be treated as misrepresentation by omission, at a minimum, and be enforced both by the Commission and

[20] Dodd-Frank Wall Street Reform and Consumer Protection Act §753
[21] Of course, this is an idealized version of the Vickers proposal, but the point is meant to be merely illustrative.

an express private right of action. This should be done in such a way as to have the effect of making the executive officer personally responsible for breaching the ring-fence, and give shareholders of the parent notice that their assets are being depleted to aid the nominally ring-fenced company.

*C. Appropriateness of Substituted Compliance*

As the foregoing discussion makes clear, any significant group of subsidiaries, whether guaranteed or not, can cause huge, lethal losses to the parent company. Therefore, substituted compliance is not appropriate for any U.S. person, including subsidiaries of a U.S. person. Substituted compliance should be reserved for non-U.S. persons who nevertheless fall under the jurisdiction of the CFTC by the "direct and significant" test, such as foreign swap dealers and major swap participants, as well as any foreign person with significant cross-exposures with one or more U.S. persons.

Similarly, substituted compliance can only be considered in cases where the alternative regulatory system is in fact equivalent to the U.S. regime, not just in form, but also in substance. At present, no such regulatory system exists, though foreign sovereigns are working towards this goal. Consequently, the CFTC should indicate explicitly that until such rules are in place internationally or on a country-by-country basis, substituted compliance will not be permitted.

*D. Guidelines for Substituted Compliance*

In cases where substituted compliance is in fact warranted, as delineated above, the CFTC must adhere to the following principles:

- Foreign regulations must be evaluated on a case-by-case basis, and cannot be given a blanket exemption for substituted compliance.

- Any foreign regulation that is determined appropriate for substituted compliance must be substantially equivalent to the relevant U.S. regulation(s) in form, in substance, and over time.

- The foreign regulatory regime must incorporate strong investigative tools and meaningful penalty provisions, and the foreign regulator must have a demonstrable commitment to enforcement and the resources to carry out such a commitment.

- Any entity making use of substituted compliance must be held responsible for immediately informing the CFTC if either the relevant regulation or the factors that qualified the entity for substituted compliance change in any material way.

- The exemption based on substituted compliance must be periodically reviewed and renewed.

However, it must be kept in mind that substituted compliance is a regulatory approach that has significant risks and opens up all sorts of opportunities for financial firms to operate in the least regulated area. This is euphuistically referred to as "regulatory arbitrage," but is nothing more than a race to the regulatory bottom so that they can increase profits by avoiding regulations that are in place to protect the American people and taxpayers.

Consequently, foreign regulations must be examined on a case-by-case basis, rather than as a blanket jurisdictional equivalence finding. Even regimes of comparable robustness will inevitably contain asymmetries that could potentially generate loopholes for risky operations. The financial industry is the among the most notorious business sectors for searching the globe to exploit such loopholes. For example, does JP Morgan Chase really need 3,391 subsidiaries or Goldman Sachs and Bank of America 2,000 each or Citigroup 1,645?[22]

Financial firms have again and again demonstrated that they are willing to go to the limits of the law (and even beyond) in search of profit. Therefore, the CFTC must evaluate individual rules for substituted compliance appropriateness, rather than entire regimes.

Second, it is not enough if a foreign rule is similar in form to its U.S. counterpart. In making a finding of substituted compliance appropriateness, it must also be so in substance and over time. The CFTC must conduct due diligence to ensure that the rule or regulation is in fact enforced. Moreover, actual enforcement must be the case not just at one moment in time, but on an ongoing basis. The CFTC must determine that there is a track record of robust enforcement by the foreign jurisdiction before making or renewing any such finding.

By the same reasoning, it is also critical that the CFTC be fully apprised of any changes in the circumstances of a firm granted access to substituted compliance in a timely manner. Firms subject to substituted compliance should be obligated to inform the CFTC of any changes to their own circumstances or the relevant rules that may have a bearing on whether substituted compliance continues to be appropriate.

The CFTC should be explicit about how it will police these requirements, and the steps it will take to enforce its cross-border application of swaps regulations. In the absence of clear guidance to this effect, foreign operations and jurisdictions will lack a sufficiently strong incentive to comply fully.

*E. Cost-Benefit Analysis*

The Proposed Interpretive Guidance is not a formal Rulemaking, and, therefore, need not comply with the requirements of Section 15(a) of the Commodity Exchange Act ("CEA").[23] This is wholly appropriate for interpretive guidance: Congress already weighed the costs and benefits of cross-border application of swaps regulations and determined that the CFTC should apply its rules to foreign activities with a "direct and significant effect" on U.S. commerce. No further consideration of the elements identified in Section 15(a) of the CEA or any other alleged costs or benefits is required, warranted, or, for that matter, proper.

Unsurprisingly, consistent with the attempt to defeat, delay or weaken financial reform by any means available, some have argued that the CFTC nevertheless engage in rulemaking and apply Section 15(a). However, what they are really seeking is an incomplete and inappropriate "industry cost-only" analysis, which will become the basis

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[22] Avraham, D., Selvaggi, P., and Vickery, J. (2012). A Structural View of U.S. Bank Holding Companies, Federal Reserve Bank of New York. *Available at* http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf.

[23] 7 U.S.C. § 19(a).

for legally challenging any rule addressing cross-border application. However, the law is clear: there is no legal duty for the CFTC to engage in a rulemaking here. Moreover, even if the CFTC were to engage in rulemaking, it would be under no duty to apply the type of cost-benefit analysis that the industry and its allies are advocating.

*Even in connection with a rulemaking, the Commission has only a limited duty simply to consider certain specified economic factors under Section 15(a), and it need not quantify or compare those factors.*

In connection with a rulemaking, three critically important principles discussed below govern the application of Section 15(a) of the CEA and the implementation of the Dodd-Frank Act. These principles make clear that, even when Section 15(a) does apply (and it clearly does not apply with respect to interpretive guidance), the Commission's obligation under Section 15(a) is far different than what the industry claims.

1. *The limited duty under Section 15(a) is simply to consider costs and benefits, not conduct a cost-benefit analysis.*

Most importantly, Section 15(a) of the CEA imposes a limited obligation on the CFTC simply to "consider" the costs and benefits of its rules in light of five specified public interest factors. [24] Congress's careful choice of words in Section 15(a), and the case law construing similar provisions, make clear that the CFTC has broad discretion in discharging this duty. In fact, the Supreme Court has long recognized that when statutorily mandated considerations are not "mechanical or self-defining standards," they "imply wide areas of judgment and therefore of discretion" as an agency fulfills its statutory duty.[25]

In fact, the CFTC has no obligation to quantify costs or benefits, weigh them against each other, or find that a rule will confer a net benefit before promulgating it. The rationale for this flexible obligation in the law is clear: requiring the CFTC to conduct a resource intensive, time consuming, and inevitably imprecise cost benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives.

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[24] Better Markets has set forth a comprehensive analysis regarding the scope of Section 15(a) in the *amicus curiae* brief it filed in support of the Commission in *ISDA v. CFTC,* Civil Action No. 11-cv-2146 (RLW) ("*Amicus* Brief") (*available at* http://bettermarkets.com/sites/default/files/Corrected%20Brief%20of%20Better%20Markets%20as%20Amicus%20Curiae%20in%20Support%20of%20Defendant%20CFTC%20Apr.%2030,%202012.pdf ). In that case, representatives of industry are challenging, *inter alia*, the Commission's consideration of costs and benefits in connection with the position limits rule. (*See also* http://bettermarkets.com/sites/default/files/ICI%20v.%20CFTC%20-%20Amicus%20Brief%20of%20Better%20Markets%20June%2025,%202012.pdf) In addition, Better Markets has written to the Office of Management and Budget ("OMB") opposing Commissioner Scott O'Malia's request that OMB review the cost benefit analysis performed by the Commission in connection with several recently finalized rules. Letter from Better Markets to Jeffrey Zients, Acting Director of OMB (Feb. 29, 2012) ("Letter to OMB") (*available at* http://bettermarkets.com/sites/default/files/O'Malia%20CBA%20letter%20to%20OMB.pdf). In the Letter to OMB, Better Markets makes clear that various executive orders and OMB guidelines requiring cost benefit analysis are inapplicable to the Commission's rulemaking. Both *Amicus* Briefs and the OMB Letter are incorporated by reference as if fully set forth herein.

[25] *Sec'y of Agric. v. Cent. Roig Ref. Co.,* 338 U.S. 604, 611 (1950).

2. *The Commission must be guided by the public interest as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry.*

The five factors that the CFTC must consider under Section 15(a) reflect Congress's primary concern with the need to fashion regulations that serve the public interest and accomplish the agency's mission, not with a need to spare industry the costs of regulation. Without exception, each factor relates to a public benefit that arises from a robustly regulated marketplace, including preventing abuse, promoting competition, enhancing transparency, and limiting systemic risk.[26]

Tellingly, none of the listed factors mentions any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements. Removing any doubt, the fifth and final factor in Section 15(a) requires the CFTC to consider generally "any **other public interest** considerations."[27]

3. *For any **rule** promulgated in accordance with the Dodd-Frank Act, the ultimate "public interest consideration" is implementing the reforms that Congress enacted to prevent another financial crisis.*

As the CFTC considers the costs and benefits of rules implementing the Dodd-Frank Act, it must give proper weight to Congress's overriding objective: to institute a comprehensive set of reforms, including a regime for regulating swaps, to prevent another financial collapse and economic crisis, including trillions of dollars in financial losses and incalculable human suffering. Therefore, as the CFTC assesses the costs and benefits of the a proposed rule – as distinguished from the interpretive guidence at issue here – under Section 15(a), it must continue to consider, above all, the benefits of the entire collection of reforms embodied in Title VII and the Dodd-Frank Act, of which a proposed rule is but one integral part.

Congress's resolve to prevent another financial crisis clearly overrides cost concerns under the Dodd-Frank Act. Congress passed the Dodd-Frank Act knowing full well that it would impose significant costs on industry, yet it determined those costs were not only justified but necessary to stabilize our financial system and avoid another financial crisis. Those costs include the elimination of extremely profitable lines of business as well as significant and ongoing compliance costs. A leading example is the establishment of the new, comprehensive regulatory regime for swaps. It will require the financial industry to incur significant costs arising from new personnel and technology, ongoing compliance, margin and collateral, and reduced revenues and profits.

Congress fully understood these costs and consequences. It knew that regulatory reform would impose costs, in some cases totaling billions of dollars. The Dodd-Frank Act reflects Congress's unflinching determination to increase the financial industry's costs across the board and very substantially—or, more accurately, to shift those costs back to industry from a society that has paid the bill for industry's unregulated excesses. In short, Congress conducted its own cost benefit analysis and concluded that the enormous

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26 7 U.S.C. § 19(a)(2).
27 7 U.S.C. § 19(a)(2)(E) (emphasis added).

collective benefits of the law far exceeded the costs and lost profits that industry would have to absorb.

Indeed, against the backdrop of the worst financial and economic crisis since the Great Depression, it is inconceivable that Congress would enact sweeping reforms and then allow the implementation of those reforms to hinge on the outcome of a rule-by-rule cost benefit analysis that ignored the overriding purpose of the new regulatory framework—and that gave controlling weight to cost concerns from the very industry that precipitated the crisis and inflicted trillions of dollars in financial damage and human suffering across the country.

In short, Section 15(a) (not some industry biased and incomplete version of a cost benefit analysis) is not required with regard to the proposed interpretive guidance relating to cross-border application of swaps regulations under the Dodd-Frank Act. And, even regarding rulemaking where Section 15(a) applies, the analytical framework set forth above for the consideration of all relevant costs and benefits must guide the application of Section 15(a).

## CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Guidance.

Sincerely,

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