February 15, 2013

Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington DC 20581

Re: Proposed Further Interpretive Guidance and Policy Statement: Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act (RIN 3038-AD85)

Dear Ms. Jurgens:

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

INTRODUCTION

Counterparty credit risk knows no boundaries. Consequently, a U.S. regime for regulating derivatives to protect the taxpayer from having to foot the bill for another bailout of the global financial system will fail unless it is backstopped by robust international application. While it is clear that United States regulators may not exceed their jurisdiction, it is equally clear that in the case of cross-border derivatives, this jurisdiction ranges far and wide. Both the law and common sense dictate that if a derivatives transaction can directly and significantly impact commerce in the United States, it must be regulated in accordance with the standards of the Dodd-Frank Act. In cases where a foreign regulator has both a legal mandate and actual track record of enforcing Dodd-Frank equivalent regulations, it is logical for the CFTC to leave regulation of the relevant transactions or entities to that foreign regulator. However, in all other cases the CFTC must – by law and by reason – enforce the provisions of the Dodd-Frank Act.

The Further Proposed Guidance is designed to build upon the Commission's earlier attempt to delineate cases in which the CFTC will regulate cross-border swaps transactions and entities from those where the task will be left to foreign regulators

---

[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.

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

under a principle of substituted compliance.[2] In the initial Proposed Guidance, this was accomplished by defining "U.S. Persons" (to be regulated by the CFTC) and "non-U.S. Persons" (to be regulated by the CFTC only in cases where their activities have a "direct and significant impact on U.S commerce" as per the statutory mandate, and where no equivalent foreign regime exists that would more naturally be expected to regulate the entity in question). It also represents a further attempt to clarify what will be required of entities subject to CFTC oversight in a cross-border swaps context.

As was emphasized in the previous comment period, the importance of these issues simply cannot be underestimated. Without strong cross-border application of Title VII of the Dodd-Frank Act, domestic swaps business will move overseas to avoid regulation, yet the risks associated with that business will remain as a direct threat to the U.S. financial system and taxpayers. In light of the enormous and ongoing costs inflicted on the American people from the most recent financial collapse and economic crisis,[3] weak cross-border application would be an egregious mistake of historic proportions which would violate the Dodd-Frank financial reform and Wall Street re-regulation law.

SUMMARY OF COMMENTS

The Release solicits comment on two specific issues: the proposed alternative approach to the definition of a U.S. Person, and a mooted alternative interpretation of the notional swaps aggregation rule. In addition to offering comment on the specific issues raised, we include discussion of related issues without which the questions of U.S. Person definition and notional swaps aggregation cannot be adequately discussed – specifically, substituted compliance. We also refer you to the further analysis presented in a previous letter on cross-border issues submitted by Better Markets to the Commission on August 27, 2012.[4]

A third issue is raised: that of distinguishing between a U.S. Person and foreign branch of a U.S. Person, with the latter being permitted to apply for substituted compliance in certain cases. This is addressed in our comments on the U.S. Person definition and on substituted compliance. Consistent with the fact – established by clear evidence from the last crisis – that the risks accrued by foreign branches, guaranteed subsidiaries, and even non-guaranteed subsidiaries all flow back to the parent entity, we believe that foreign branches of U.S. Persons should under no circumstances be subject to weaker regulation than the parent company.

A. U.S. Person Definition

The original Proposed Guidance mistakenly distinguished between branches and subsidiaries, and between guaranteed and non-guaranteed subsidiaries. As the last crisis

---

2 *See* Better Markets Comment Letter "Proposed Interpretive Guidance and Policy Statement: Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act", (August 27, 2012), ("Better Markets Cross-Border Letter") (incorporated as though fully set forth herein) *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58706&SearchText=better%20markets.

3 BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_0.pdf.

4 Better Markets Cross-Border Letter.

proved, in situations of market stress, a large trader simply cannot afford the reputational damage associated with allowing a subsidiary to fail, even if that subsidiary is not explicitly guaranteed. Therefore, any subsidiary of a U.S. Person, whether guaranteed or not, must also be included in the definition of a U.S. Person. The amendments suggested in the Further Proposed Guidance fail to correct this earlier mistake.

B. Aggregation of Notional Swaps

The aggregation of swaps for the purpose of determining who counts as a Swap Dealer ("SD") is of central importance to the entire cross-border swaps regulatory program. The weakness of the domestic SD and related entity definitions rule has already created a risky environment in which **not a single entity** is classed as a Major Swap Participant ("MSP").[5] There is no reason to believe that foreign firms will be more likely to fall under the excessively high MSP threshold than domestic firms. Therefore, if large overseas entities heavily active in the swaps markets are to be subjected to proper oversight it is only under the mantle of SDs that they will become so. The new proposals are a significant improvement over the original approach outlined in the Proposed Guidance.

C. Substituted Compliance

As the Commission recognizes, substituted compliance is in no case appropriate for U.S. Persons, even when they enter into transactions overseas. The swap activities of a U.S. Person directly and immediately impact the United States and endanger the U.S. taxpayer if improperly regulated.

However, even the swap activities of non-U.S. Persons can have a direct and significant impact on U.S. commerce. Hence, under the Dodd-Frank Act, the CFTC is mandated to regulate those persons and their activities insofar as they meet that criterion. Although the statute itself does not provide for substituted compliance in such cases, the Commission has decided that principles of international comity and regulatory cooperation warrant such allowances where an equivalent foreign regulatory regime exists that would more naturally be expected to regulate the entities in question.

In cases where the overseas regime is **in fact** equivalent, not only in form but also in substance, enforcement and, over time, a case can indeed be made for substituted compliance. At the same time, the Commission must recognize that no foreign regime, even a seemingly substantively equivalent one, will ever have the interests of the U.S. public as their top priority, unless they happen to coincide with that regime's domestic interests. Substituted compliance must therefore be applied sparingly, and only in cases where adequate precautions have been taken.

Specifically, 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

---

5 According to the NFA registry *available at* https://www.nfa.futures.org/NFA-swaps-information/SD_MSP_Registry.xml Correct at time of writing. Accessed February 6, 2013.

regulations or qualifications that originally underlay the allowance of substituted compliance

DISCUSSION

Our comments cover the three substantive issues identified above. First, however, we remind the Commission that substantial treatment of these and other related topics is contained in our previous comment letter.[6] In addition, several other public interest groups have given well-thought out input on an array of issues arising from and related to the initial Proposed Guidance.[7] Yet, while the Proposed Further Guidance makes reference to several letters submitted by financial industry groups, there is no express indication that any of the comments submitted by public interest groups were in fact considered by the Commission in connection with the Release. The Commission must use this opportunity when issuing any further release pertaining to cross-border application of swaps rules, whether that be in the form of a final guidance or additional proposals, to in fact consider all views submitted – in connection with this Release as well as the prior release – and to ensure that any further guidance reflects all comments submitted.

We now address the substantive topics listed above.

A. U.S. Person Definition

As demonstrated in our previous comment letter, the legal concept of a "U.S. Person" must be broadly defined, including at the very least any branch or majority-owned subsidiary of an entity that is headquartered, incorporated, or otherwise controlled in the United States, regardless of whether there are explicit financial guarantees in place from the parent company.

The precise corporate form in which a firm chooses to organize its geographically dispersed operations has no bearing on the degree to which the swap-related risks generated by those operations feed back to the parent company. Distinctions like "branch" versus "guaranteed subsidiary" create the illusion of varying degrees of immunity from contagion where in reality none exist. Moreover, it elevates form over substance and invites regulatory arbitrage.

This is clearly borne out by the experience of the last financial crisis. AIG Financial Products was a subsidiary of AIG with huge OTC derivatives activities in London, supposedly under the purview of the UK's Financial Services Authority. The losses on its Credit Default Swap ("CDS") trades necessitated a $182 billion bailout of the parent company by the U.S. government and taxpayer.[8] Citibank and Bear Stearns also suffered major losses passed through from affiliates housed in the Cayman Islands.[9]

These transfers of losses to the parent company are not merely features of the financial crisis. Just last year, JP Morgan suffered enormous losses from derivatives trades

---

6 Better Markets Cross-Border Letter.

7 *See* Letters submitted by Michael Greenberger, Americans for Financial Reform and Public Citizen, all dated August 27, 2012.

8 Bailout Tracker, ProPublica, *available at* http://projects.propublica.org/bailout/entities/8-aig.

9 Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act; Proposed Rule, Appendix 2 – Statement of Chairman Gary Gensler, 77 Fed. Reg. 41238, (July 12, 2012).

executed through its London Head Office (a branch), wiping over $20 billion from its market capitalization.[10] Similarly, in 2011 UBS lost over $2 billion (which at one point threatened to rise to $15 billion) when a trader in its London office made fraudulent bets in derivatives markets.[11] The trades were all conducted through a foreign branch (London), but the losses went straight to the parent company.[12]

In fact, there is a long history of parent companies taking huge losses from the derivatives trading activities of their foreign subsidiaries and affiliates. As far back as 1993, Shell took losses that ultimately exceeded $300 million when its 50 percent-owned Japanese subsidiary Showa Shell Kekiyu ("SKK") lost $1billion on foreign exchange swaps.[13] To put that in perspective, the Shell loss is equivalent to almost half a billion in today's dollars. At the time, Shell made much of the fact that SSK was "only an associate, not a full-blown [i.e. wholly owned] subsidiary."[14] Clearly, this made no difference when it came to the flow of losses back to the parent company.

There is no substantive difference between a branch and a subsidiary of a U.S. Person when it comes to covering derivatives losses. Both must be held to the same high standards of regulation – those applicable to the U.S. Person itself. To do otherwise is to expose the U.S. taxpayer to the risk of another massive bailout. [15]

The Commission should disregard unsupported scenarios presented by industry groups who seek to scare and intimidate the CFTC into finalizing a toothless Cross Border Interpretive Guidance.

With nothing more than self-serving statements, several commenters, when arguing for an excessively narrow definition of U.S. Person, have threatened that U.S.

---

10 "JPMorgan roiled by wake of the 'Whale,'" Financial Times, July 13, 2012, *available at* http://www.ft.com/cms/s/0/264314e2-ccf9-11e1-b78b-00144feabdc0.html#axzz2Kc02SuJy.

11 "UBS rogue trader Kweku Adoboli jailed for seven years," Financial Times, November 20, 2012, *available at* http://www.telegraph.co.uk/finance/financial-crime/9690206/UBS-rogue-trader-Kweku-Adoboli-jailed-for-seven-years.html.

12 "FSA fines UBS £29.7 million," Lexology, November 29, 2012, *available at* http://www.lexology.com/library/detail.aspx?g=4ceda0c8-e538-4fd4-9bf2-9decca445fd4.

13 "Hazards in the currency game: Disclosure by Shell of a dollars 200m loss highlights the perils of dealing. Russell Hotten reports," The Independent, February 28, 1993, *available at* http://www.independent.co.uk/news/business/hazards-in-the-currency-game-disclosure-by-shell-of-a-dollars-200m-loss-highlights-the-perils-of-dealing-russell-hotten-reports-1475785.html.

14 "Shell Gains Despite Currency Fiasco," New York Times, February 26, 1993, *available at* http://www.nytimes.com/1993/02/26/business/worldbusiness/26iht-shel_1.html.

15 The difference between a branch and a subsidiary is of no practical significance when it comes to contagion risk. 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.

financial institutions will suffer a competitive disadvantage when doing business overseas if they have to bear the stigma of being classed as a "U.S. Person." [16]

The American Bankers Association, for instance, makes several vague and ominous predictions about the cross-border application of Dodd-Frank swaps rules "hindering overseas branches of U.S. banks from participating in local swaps markets" [17] No evidence is provided to support this, beyond a weak anecdotal claim that "our member institutions have indicated that foreign competitors abroad are already actively seeking to limit their activity with U.S. Persons…while seeking to attract our customers by warning them that U.S. regulations will raise costs…decrease quality or availability of service, or…even result in the customer becoming subject to U.S. regulatory requirements."[18]

Based on this anecdotal claim, the ABA argues that only entities housed in the United States should be classed as U.S. Persons. They go so far as to claim that even foreign branches of U.S. entities should be free from classification, or else they will find no foreign counterparties willing to do business with them. Such an argument is absurd. Taken literally, it seems to suggest that the CFTC should exempt **all** overseas swap activity from Title VII requirements, even that which has a clear direct and significant impact on U.S. commerce such as swap activity by foreign branches of U.S. financial institutions. This would, of course, directly violate Congress's clear intent as expressed in unambiguous language in the Dodd-Frank Act.

The argument put forward by the ABA (and others like them) rests on unrealistic assumptions. First, they make the implausible claim that foreign counterparties will restructure entire business lines and activities due to nothing more than vague and nonspecific threats by non-U.S. Persons of "higher costs" and "reduced…availability of services." Without any evidence, it appears implausible that such amorphous concerns will cause them to cease entering into swaps with U.S. Persons without, for example, conducting their own analysis.

Second, they suggest that foreign firms so fear the prospect of being "forced" to register as an SD or MSP if they enter into swaps with U.S. Persons that they will avoid all contact with them. This argument overlooks three key points. First, plenty of large foreign firms have already registered as swap dealers or expressed an intention to do so.[19] Second, given the $8 billion *de minimis* threshold, it would border on irrational for a firm to avoid all swap transactions with U.S. Persons given they are permitted such a large amount of potentially lucrative swap dealing activity without triggering a registration requirement. "Better safe than sorry" is, after all, not a mantra that appears to be prevalent among financial entities dealing in swaps.[20] Third, and perhaps most

---

[16] *See* e.g., the letter from the American Bankers Association dated August 27, 2012 ("ABA Letter").

[17] *See* e.g. ABA Letter p. 1

[18] Op. Cit. p. 2

[19] According to the NFA registry *available at* https://www.nfa.futures.org/NFA-swaps-information/SD_MSP_Registry.xml.

[20] *See* e.g. "Danske Bank chief sorry for role in crisis", Financial Times, December 20, 2012, *available at* http://www.ft.com/intl/cms/s/0/5911f600-4aac-11e2-968a-00144feab49a.html; "HSBC 'sorry' for aiding Mexican drugs lords, rogue states and terrorists," The Guardian, July 17, 2011, *available at*

important of all, the SD registration requirement is only triggered by swap **dealing** activities. Commercial hedging activities and even run of the mill speculative trading are both explicitly excluded from the transactions that must be counted towards the $8 billion threshold. The scare tactic that no overseas firm will enter derivatives trades with a U.S. Person is no more than the latest attempt by self-interested financial industry participants to frighten the CFTC into weakening the cross-border application of Dodd-Frank.

Last but not least, to the extent that foreign firms do in fact fear "contamination" of meaningful regulation by transacting with a U.S. Person, the CFTC should see this as a need to apply a broad and strict interpretation of its cross-border mandate. Properly understood, this is clear evidence that at least some foreign firms are clinging to the hope that their own domestic regulations will come out weaker than those of Dodd-Frank. This is a clear warning that such firms will seek to exploit regulatory arbitrage wherever they can – creating a riskier derivatives marketplace where the risk ultimately feeds back to the United States taxpayer. The CFTC must hold a firm line to ensure that such evasion is not possible.

The proposed alternative definition of a U.S. Person is a step backwards from the original proposal.

While the initial proposed definition of U.S. Person already contained several areas of weakness (as set forth in our prior letter[21]), the definition offered in the Further Proposed Guidance creates one more. The proposed alternative definition excludes even directly or indirectly majority-owned subsidiaries of a U.S. Person unless the owner also "bears **unlimited responsibility** for the obligations and liabilities of the legal entity."[22] The original definition had a more inclusive requirement that the U.S. parent need only be "responsible for the liabilities" of the owned entity, which was already excessively narrow because a lack of explicit guarantee proved in the last crisis to be no obstacle to a *de facto* absorption of liabilities by the parent. Just one example was Citigroup, which took $25 billion of liabilities (that were quickly worthless) from SPVs without any guarantees or legal requirement to do so – this was one of the key reasons Citigroup had to be bailed out with almost $500 billion of aid from the U.S. government and taxpayer.[23]

The Proposed Further Guidance would allow for the absurd scenario that a U.S. parent could **explicitly** guarantee the majority of a foreign subsidiary's operations, including **all** of its swaps activities, and yet that subsidiary would be exempted from U.S. Person status. This is precisely the sort of loophole the CFTC must avoid – it would allow all the risk to flow back to the United States taxpayers with no U.S. oversight or regulation of the swap activities in question.

---

http://www.guardian.co.uk/business/2012/jul/17/hsbc-executive-resigns-senate; and, the myriad other purportedly heartfelt apologies from bank executives that appear on a too regular basis.

21 Better Markets Cross-Border Letter, p. 6-10.

22 78 FR 909, 912 (January 7, 2013) (emphasis added). Compare to the July definition, which included entities owned by a U.S. Person where the U.S. Person was "responsible for the liabilities" of the entity. *See* 77 Fed. Reg. at 41218. Additionally, the January definition directly excludes Limited Liability Companies, and Limited Liability Partnerships, as well as excluding commodity pools and collective investment vehicles such as hedge funds.

23 Better Markets Cross-Border Letter, p. 7-8.

That would be an express violation of the letter and spirit of the law and would needlessly and foolishly put U.S. taxpayers on the hook for such activities.

B. Aggregation of Notional Swaps

The new proposals represent a significant improvement on the original Proposed Guidance with respect to the aggregation of swaps for the purpose of determining who counts as a Swap Dealer. This issue is of central importance to the entire cross-border swaps regulatory program. As mentioned above, the weakness of the domestic SD and related entity definitions rule has already created a risky environment in which **not a single entity** is classed as a Major Swap Participant.[24] There is no reason to believe that foreign firms will be more likely to fall under the excessively high MSP threshold than domestic firms. Therefore, if large overseas entities heavily active in the swaps markets are to be subjected to proper oversight it is only under the mantle of SDs that they will become so.

Under the old proposals, foreign firms would not need to include any of the swap dealing activities of their U.S. affiliates when determining whether they meet the SD threshold. The CFTC has wisely reconsidered this approach. Under the new proposals, foreign firms would be required to count all swap dealing activities entered into by any affiliates under common control, except in cases where the relevant affiliate is independently registered as an SD. This is a far better approach, as it avoids the absurd scenario of the original proposal in which derivatives transacted on U.S. soil, potentially on U.S. platforms and therefore with a direct impact on the value of other derivatives transacted in the U.S. (those traded by U.S. firms), would simply disappear from the regulatory purview for the purpose of determining SD status. As per the statute, no transaction with a direct and significant impact on U.S. commerce – as any swap entered into by a firm housed within U.S. borders must clearly have – can be ignored for the purpose of SD registration.

More intricate is the question of whether non-U.S. affiliates of non-U.S. Persons registered as SDs should themselves be required to register as SDs if they engage in any amount of swap dealing. In essence, the Commission's key insight is correct: a weakening of this provision would open an unacceptable loophole that would incentivize non-U.S. SDs to propagate numerous non-U.S. affiliates simply to avoid regulatory oversight. On the other hand, it is conceivable that some firms might suffer unnecessarily if they were forced to register as SDs despite the fact that they only engage in a *de minimis* amount of swap dealing.

The issue is complicated by the extremely high *de minimis* threshold established by the SD definitions rule. An $8 billion threshold is – as has been argued in our letter on the relevant rule[25] – too high in any context. In the specific scenario envisaged in the

[24] According to the NFA registry *available at* https://www.nfa.futures.org/NFA-swaps-information/SD_MSP_Registry.xml. Correct at time of writing. Accessed February 6, 2013.

[25] Better Markets comment letter "Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant;"" (April 6,

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

Further Proposed Guidance, this is doubly so. Allowing a subsidiary of an already large and highly active firm (i.e. an SD) to trade billions of dollars of swaps annually without the enhanced protections required of SDs would be a huge gamble.

A *de minimis* allowance for subsidiaries of SDs closer to the $100 million level originally proposed by the Commission[26] would achieve the best of both worlds. It would enable subsidiaries of non-U.S. SDs to deal a genuinely *de minimis* quantity of swaps without thereby being required to register as an SD, while at the same time preventing a proliferation of large, under-regulated, opaque, and interconnected derivatives desks that all ultimately feed back into systemically important financial institutions.

C. Substituted Compliance

Although the G-20 committed to central clearing of most derivatives by the end of 2012, so far the United States and Japan are the only nations to accomplish this.[27] This is merely symptomatic of a broader mismatch between the successful implementation of necessary financial reforms in the United States following the financial crisis and the much slower and weaker reforms overseas. It now appears that robust derivatives regulatory reform may not be finalized within the EU until 2019, and that the final rules may end up weaker than those originally proposed.[28]

Indeed, in a letter to the Commission, ISDA has laid out a compelling picture of why substituted compliance can only be applied in a case-by-case manner, rather than on an overall jurisdictional basis. Though they draw the wrong inference from it, they rightly point out that "[t]he G-20 commitments, after all, were to certain broad regulatory goals, not to global adoption of the Commission's paradigm of detailed regulation."[29] Given that this is so, and given also that these commitments show no immediate prospect of even being implemented in most of the relevant jurisdictions outside of the United States, the idea that the CFTC might grant substitutability for an entire foreign derivatives regulation regime, or – as ISDA and others have requested – an indefinite delay in cross-border application of Title VII provisions until such time as foreign regimes have caught up is preposterous.

As ISDA notes, even Europe and Japan are nowhere near achieving comparability.

2012), *available at* http://www.bettermarkets.com/sites/default/files/CFTC-%20Supp%20CL-%20SD,%20MSP%20Def%20w%20attachment-%204-6-12_0.pdf.

[26] 75 FR 244, December 21, 2010. *See also* Better Markets comment letter "Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant,"" (February 22, 2011), *available at* http://www.sec.gov/comments/s7-39-10/s73910-68.pdf; and note 15 *supra*.

[27] Financial Stability Board, "OTC Derivatives Market Reforms" (June 15, 2012), p. 3, *available at* http://www.financialstabilityboard.org/publications/r_120615.pdf.

[28] "Global Regulators Said to Weigh Delay of Derivative Margin Rules," Bloomberg Businessweek, January 24, 2013, *available at* http://www.businessweek.com/news/2013-01-24/global-regulators-said-to-weigh-delay-of-derivative-margin-rules.

[29] Letter from ISDA dated August 10, 2012.

MiFID II may not be in place until 2015, and even then will require implementation by individual European member states.[30] Although Japan has implemented mandatory central clearing for some swaps, its scope is far narrower than that of Title VII. Additionally, its regime lacks real-time reporting, confirmation, and margin requirements for uncleared swaps – all central aspects of the Title VII approach.[31] To grant blanket substitutability would therefore eliminate requirements that Congress deemed necessary to curtail systemic risk and protect the American taxpayer, despite the fact that swaps activity subject to these weaker requirements would have a direct and significant impact on U.S. commerce – the criterion Congress set out for cross-border application of Title VII.

The problem runs deeper than just the pace of derivatives regulation. The incentives for overseas regulators and legislators are simply not the same as those in the United States. As the Standard Chartered and HSBC money laundering cases,[32] along with the Libor scandal,[33] demonstrated, foreign regulators are more prone to a "light touch" approach.[34] The key difference is that the United States, as the ultimate backstop to the global financial system, has a greater incentive to prevent the need for another bailout. Clearly, there is an issue of regulatory culture, where – by the FSA's own admission – foreign regulators are less likely to act assertively and regulate meaningfully.[35] Until overseas jurisdictions prove that they have risen to meet the standards of the United States, substituted compliance is simply not a viable or acceptable option because it will not protect the U.S. financial system, taxpayer, or economy as Congress has directed the CFTC to do.

If and when foreign jurisdictions establish genuinely equivalent regimes for regulating derivatives, there will no longer be a need for the CFTC to police transactions between entities operating in those jurisdictions. Until that day comes, however, the law is clear that the CFTC must police overseas swaps transactions to the extent that they have a direct and significant impact on U.S. commerce.

As the discussion above makes clear, there can be no doubt that the swap activities of non-U.S. Persons can have a direct and significant impact on U.S. commerce. The numerous instances of overseas swaps bets by foreign subsidiaries coming back to haunt the parent company are incontrovertible. Moreover, the financial crisis proved that the interconnectedness of large financial institutions renders U.S. Persons entirely vulnerable to contagion from large overseas entities. Hence, the law requires the CFTC to police such activities and entities according to the rules laid out in Title VII of the Dodd-Frank. In

---

[30] Op. Cit. p. 6

[31] *Id.*

[32] "HSBC to Pay $1.92 Billion to Settle Charges of Money Laundering," New York Times, December 10, 2012, *available at* http://dealbook.nytimes.com/2012/12/10/hsbc-said-to-near-1-9-billion-settlement-over-money-laundering/.

[33] "Timeline: Libor-fixing scandal," BBC, February 6, 2013, *available at* http://www.bbc.co.uk/news/business-18671255.

[34] "Reputation is crucial for bank investors," Financial Times, December 21, 2012, *available at* http://www.ft.com/intl/cms/s/0/26c1b3c6-4b5f-11e2-88b5-00144feab49a.html#axzz2JQxD48bv.

[35] "London Self-Regulatory System Proves Illusory in Libor Scandal," Bloomberg, July 15, 2012, *available at* http://www.bloomberg.com/news/2012-07-15/london-self-regulatory-system-proves-illusory-in-libor-scandal.html.

other words, for all intents and purposes they should be regulated as though they were domestic transaction.

Although the statute itself does not provide for substituted compliance in such cases, the Commission has decided that principles of international comity and regulatory cooperation warrant such allowances where an equivalent foreign regulatory regime exists that would more naturally be expected to regulate the entities in question.

In cases where the overseas regime is **in fact** equivalent not only in form but also in substance, enforcement and, over time, a case can indeed be made for substituted compliance. At the same time, the Commission must recognize that no foreign regime, even a seemingly substantively equivalent one, will ever have the interests of the U.S. public as their top priority, unless they happen to coincide with that regime's domestic interests. Substituted compliance must therefore be applied sparingly, and only in cases where adequate precautions have been taken.

Specifically, 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.

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.

Case-by-case basis

Certain industry groups have argued that a blanket allowance should be granted for substituted compliance within an overseas jurisdiction, so long as that jurisdiction is

deemed to be of similar comprehensiveness to that of the United States.[36] They argue that mixing and matching rules from different regimes (as would occur were substituted compliance granted only on a provision-by-provision basis) would lead to a Frankenstein structure that lacked the coherence of a single-regime approach.[37]

This argument is wrongheaded. Selective substituted compliance would preserve the overarching framework of Title VII, while allowing certain compliance requirements to be substituted for equivalent foreign requirements to avoid duplication. Indeed, Barclays – an advocate for blanket substituted compliance – has acknowledged Title VII to be a "holistic approach," the provisions of which "interrelate in complex ways."[38] Such an approach is only as strong as its weakest link, and therefore the Commission must not allow the weaknesses of a foreign regulatory regime to be imported simply because some aspects of it are comparable in robustness to those of Title VII.

Given that the protection of the U.S. financial system, taxpayers, and economy are at stake and that the law is strong and clear, the Commission simply does not have the legal authority to grant such self-serving industry requests, which would incentivize regulatory arbitrage and increase systemic risk.

CONCLUSION

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

Sincerely,

Dennis M. Kelleher
President & CEO

David Frenk
Research Director

Better Markets, Inc.
Suite 1080
1825 K Street, N.W.
Washington, D.C. 20006
(202) 618-6464

dkelleher@bettermarkets.com
dfrenk@bettermarkets.com

www.bettermarkets.com

---

36 *See* letters from Global Financial Markets Association and from the Futures and Options Association, both dated August 13, 2012.

37 *See* letter from Barclays dated August 27, 2012.

38 Op. Cit.