April 19, 2013

The Honorable Elise B. Walter
Commissioner
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Cross-Border Regulation

Dear Commissioner Walter:

We applaud you for your attention to the critical issues raised by cross-border regulation. Your speeches before the American Bar Association Spring Meeting on April 6, 2013 and the Australian Securities and Investments Commission on March 24, 2013, addressed a number of key issues relating to the cross-border regulation of securities and securities-based swaps markets. Better Markets, Inc.[1] has spent a great deal of time on this topic and I wanted to share our views with you and the Commission.

In your remarks, you expressed the belief that there is a "reasonable and necessary middle ground" between the application of U.S. law to all cross-border financial activity and reliance on substituted compliance by foreign jurisdictions.[2] While that is unquestionably accurate, U.S. regulation must be guided by the fact that cross-border financial activity can have a dramatic impact on U.S. financial markets and institutions, as was so clear during the financial crisis of 2008 and subsequently. Moreover, the process of implementing financial reform overseas is lagging well behind the process here in the U.S. Therefore, whether or not the U.S. can or should rely on foreign regulatory standards "to the maximum extent possible" will depend heavily on the degree to which foreign regimes can demonstrate equivalence to the essential standards established by the Dodd-Frank Act.

Given these realities and the imperative to protect the American people from another devastating financial and economic crisis,[3] **the SEC must establish strong regulation of cross-border activity under *U.S. law,* and rely on substituted**

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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.

2 Speech before Australian Securities and Investments Commission on March 24, 2013 ("Speech") at 5.

3 *See* BETTER MARKETS, THE COST OF THE WALL STREET 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.pdf.

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

compliance only after a determination that those foreign standards are truly comparable.

There should be no dispute that where genuinely equivalent regulation exists overseas, U.S. regulators should rely on the foreign regime. In this sense, there is indeed a potential "middle ground," since it is to be hoped that foreign jurisdictions will eventually catch up with the standards set by U.S. financial reform. However, as the analysis below details, there is only one appropriate way to move toward this middle ground, and that is to operate on the presumption that U.S. law will be enforced globally unless and until there is a demonstrable equivalence in foreign regulation. This equivalence must exist not only in form, but also in substance. And, there must be a proven compliance track record, especially in the enforcement arena.

In short, form cannot control over substance, and even similar laws are of little value if they are not meaningfully and consistently enforced. Thus, proof over promises must be required.

In this letter, we outline some core principles that we believe the SEC must apply as it formulates its rules and/or guidance in this area. Many of these points were included in our comment letters to the CFTC as it developed its guidance on the cross-border application of swaps regulation. Copies of those letters are enclosed. Although the provisions in the Dodd-Frank Act regarding cross-border regulation by the CFTC and the SEC are different, the fundamental principles are the same. Similarly, although our points are framed largely in terms of derivatives regulation, they apply more broadly to cross-border regulation of all financial markets and products.

1. Without strong cross-border application of U.S. regulations, systemic risk will not be adequately curbed; revenue and jobs in the financial sector will migrate overseas; and the risk of loss will remain with the U.S. taxpayer.

You are absolutely right in observing that financial markets are increasingly global, interconnected, and interrelated. Therefore, the new U.S. regime for regulating derivatives and other products will fail unless it is backstopped by robust international application.

To do otherwise would be to invite a global race to the bottom where financial organizations jockey for the least regulation, playing one country against another. This will almost certainly lead to another devastating financial crisis—and another U.S. taxpayer bailout of the global financial system.

Weak cross-border regulatory standards not only raise the specter of global systemic risk and failure, they pose a special threat to U.S. interests. If the U.S. laws are not applied cross-border, then U.S. corporations will move certain operations overseas, and those host countries will then enjoy increased employment and revenue. However, when the less regulated foreign investments and trading activities go awry and those operations generate lethal losses, those losses will inevitably come back to the parent

companies in the U.S. As a result, U.S. taxpayers will have to bail out those institutions if they are systemically significant—which is precisely what happened last time.

That is to say, if U.S. regulations are not robustly applicable overseas, directly or by real substituted compliance, then financial activities, employment, revenue, and taxes will flee overseas. Foreign jurisdictions will enjoy the upside of that migration, but the downside of costly bailouts will fall on and burden the American taxpayer. This is unacceptable.

2. ***"U.S. person" must be broadly defined.***

The precise corporate form in which a firm chooses to organize its geographically dispersed operations has no bearing on the degree to which the risks generated by those operations feed back to the U.S. 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.

Therefore, the legal concept of a "U.S. Person"—or its equivalent under the SEC's framework—must include 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.

This approach is clearly warranted in light of 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.[4]

Citibank and Bear Stearns also suffered major losses passed through from affiliates housed in the Cayman Islands.[5] In fact, tens of billions of dollars of losses to Citigroup in 2008 illustrate the danger posed by entities that are merely sponsored by financial institutions without any formal or informal guarantee or obligation.[6]

Citigroup was a large sponsor of so-called "structured investment vehicles" ("SIVs"), large conduits that funded longer-maturity assets with short-term borrowing, including lots of asset-backed commercial paper ("ABCP"). The SIVs were set up to be bankruptcy remote. That is, if they lost money, the originating institution was not

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

5 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).

6 *See* Better Markets Comment Letter, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," December 19, 2012, at 8, note 21, *available at* http://www.bettermarkets.com/sites/default/files/CL%20FSOC%20SIFIs%2012-19-11.pdf.

responsible or liable and investor recovery was limited to the pool of assets in the SIV. After the subprime lending crisis began in 2007, SIVs took losses and there was a widespread run by ABCP creditors. Although Citi had no legal obligation to do so, in late 2007 it moved $49 billion of assets from SIVs it had originated onto its balance sheet and absorbed the SIV losses to prevent damage to its reputation.[7]

Having incurred $49 billion in losses for which it had no legal liability along with other massive losses from its reckless investments and trading, Citigroup was almost certainly technically bankrupt and would have failed in the Fall of 2008 but for being rescued and bailed out by U.S. taxpayers and the government. Indeed, Citigroup ultimately received the most aggregate government support for any single institution: $476.2 billion.[8]

These transfers of foreign-generated and other losses to the U.S. parent company are not merely features of the financial crisis. Just last year, JP Morgan suffered enormous losses from derivatives trades executed through its London Head Office (a branch), causing over $6 billion in direct losses and wiping over $20 billion from its market capitalization.[9] 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.[10] The trades were all conducted through a foreign branch (London), but the losses went straight to the parent company.[11]

There is no substantive difference between a branch and a subsidiary of a U.S. Person when it comes to covering market losses. Both types of entities must be held to the same high standards of regulation—those applicable to the U.S. Person itself. Otherwise, financial institutions will once again use form to evade regulation and the U.S. taxpayer will be exposed to the risk of another massive bailout.[12]

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7 *See* Better Markets Letter, *supra* note 6; *see also* Bloomberg News, "Citigroup To Consolidate Seven SIVs Onto Balance Sheet," December 13, 2007, *available at* http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aT0Ix2iDnZRk.

8 *See* Congressional Oversight Panel (2011), March Oversight Report, Figure 7, *available at* http://cybercemetery.unt.edu/archive/cop/20110401232213/http://cop.senate.gov/documents/cop-031611-report.pdf.

9 "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.

10 "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.

11 "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.

12 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.,

3. ***The Commission should adopt a narrow approach to substituted compliance that protects U.S. taxpayers.***

In cases where an overseas regulatory regime is **in fact** equivalent to U.S. standards, in form and substance, in its enforcement application, 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. To do otherwise would be the equivalent of giving foreign citizens a put on U.S. taxpayers to bailout global financial institutions for activities that take place overseas.

Specifically, insofar as substituted compliance is permitted, it must adhere to four key principles: (1) equivalence in form and substance that remains constant over time; (2) a demonstrable track record of actual enforcement; (3) a duty upon 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; and (4) a determination of comparability on a case-by-case analysis, rather than on a jurisdictional basis, which could result in widely divergent compliance across markets.

In your remarks before the American Bar Association, you noted that "I personally support an approach that would permit a foreign market participant to comply with requirements imposed by its home country that are comparable with U.S. regulation, so long as it abides by U.S. requirements in areas where the home country's regulations are not comparable."[13] You rightly contrasted this with a blanket "reciprocity" approach and specified that the approach you endorse would rely on case-by-case comparisons of rulemaking topics rather than an overall jurisdictional comparison.[14] Moreover, you made it clear that "in making these determinations, one would look not just at the way in which a country's laws and regulations are written, but also, and crucially, at how that country supervises and enforces compliance with its rules."[15] Better Markets agrees wholeheartedly with these sentiments, and we applaud your highlighting the need for a strong enforcement track record to be established by a foreign regime before substituted compliance can be considered.

The SEC must also recognize the current mismatch between the successful implementation of necessary financial reforms in the United States following the financial crisis and the much slower and/or weaker reforms overseas. For example,

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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.

[13] Speech before American Bar Association, April 6, 2013, *available at* http://www.sec.gov/news/speech/2013/spch040613ebw.htm

[14] *Id.*

[15] *Id.*

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.[16] Indeed, 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 significantly weaker than those originally proposed.[17]

All of these considerations support a cautious approach to determining whether or not substituted compliance is in fact merited.

4. ***The Commission should give little weight to unsupported scenarios presented by industry groups who seek to establish weak cross-border regulation.***

In the debate over cross-border application of U.S. standards, industry representatives have raise alarms that U.S. financial institutions will suffer a competitive disadvantage when doing business overseas if they are determined to be a "U.S. Person."[18] These and similar arguments tend to be based on vague anecdotes and false assumptions, rather than actual data or independent, unbiased analysis. As a result, they deserve little weight.

To the extent that foreign firms do in fact fear meaningful regulation when they transact with a U.S. Person, the SEC should see this as confirming the need to apply U.S. standards broadly. Properly understood, this is clear evidence that at least some foreign firms are clinging to the hope that their own domestic regulations will be weaker than those adopted by U.S. regulators.

This is a clear warning that such firms will seek to exploit regulatory arbitrage—creating a dangerous marketplace where the risk of foreign activities ultimately feed back to the United States taxpayer. The SEC must hold firm to ensure that such evasion is not possible.

5. ***In its analysis of economic factors, the SEC should adhere to the statutory standards and should consider the utmost importance of avoiding another financial crisis.***

Sections 3(f) and 23(a)(2) of the Exchange Act set forth the SEC's narrow statutory obligation to "consider" a rule's impact on several specific economic factors.[19] However, even when the SEC has clearly fulfilled these limited statutory duties, representatives from industry nevertheless claim, without merit, that the SEC has failed

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

17 "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.

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

19 15 U.S.C. §§ 78c(f), 78w(a)(2).

to appropriately conduct what the industry incorrectly and misleadingly calls "cost-benefit analysis." Therefore, as the SEC drafts its rules on cross-border regulation, it should bear in mind several principles governing the true scope of the SEC's statutory obligation.[20]

A. Under the securities laws, the SEC has no statutory duty to conduct cost-benefit analysis.

When Congress intends cost-benefit analysis to apply, it explicitly refers to "costs" and "benefits" and specifies the nature of the analysis,[21] yet Sections 3(f) and 23(a)(2) of the Exchange Act contain no such language. Moreover, 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.[22] The rationale for this flexible obligation is clear: requiring the SEC to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis would significantly impair the agency's ability to implement Congress's regulatory objectives.

B. The SEC must be guided by the public interest and the protection of investors, not by concerns over the costs of regulation imposed on industry.

The SEC's preeminent duty when promulgating rules has always been protecting investors, the public interest, and the integrity of the markets. The financial crisis of 2008 is a powerful reminder of the need to remain focused on these overriding purposes of securities regulation.[23]

C. For any rule aimed at financial reform, the ultimate public interest is preventing another financial crisis.

A study by Better Markets estimates that the dollar cost alone of the financial crisis will exceed $12.8 trillion.[24] In addition, the Government Accountability Office has issued a study observing that "the present value of cumulative output losses [from the

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[20] For a detailed analysis of the SEC's limited obligation to consider economic factors during the rulemaking process, *see* BETTER MARKETS, SETTING THE RECORD STRAIGHT ON COST-BENEFIT ANALYSIS AND FINANCIAL REFORM AT THE SEC, at 39-44 (July 30, 2012), *available at* http://bettermarkets.com/sites/default/files/CBA%20Report.pdf.

[21] *See American Textile Mfrs. Inst., Inc. v. Donovan*, 452 U.S. 490, 510-512 & n. 30 (1981) (stating that "Congress uses specific language when intending that an agency engage in cost-benefit analysis" and citing numerous statutory examples).

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

[23] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186-87 (1963) (quoted authorities omitted).

[24] *See* 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.

crisis] **could exceed $13 trillion.**"[25] Therefore, as the SEC considers the public interest and the protection of investors under Sections 3(f) and 23(a)(2), it must continue to consider, above all, the benefits of the entire collection of reforms embodied in the Dodd-Frank Act, of which any specific rule is but a single, integral part.

D. Congress's resolve to prevent another financial crisis clearly overrides any industry-claimed cost concerns.

Congress passed the Dodd-Frank Act knowing full well that it would impose—or reallocate—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.

Against the backdrop of the worst financial and economic crises 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 biased, one-sided 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.[26]

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[25] U.S. GOVERNMENT ACCOUNTABILITY OFFICE, FINANCIAL REGULATORY REFORM: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, GAO-13-180, at 17 (Jan. 2013) (released Feb. 14, 2013), *available at* http://gao.gov/assets/660/651322.pdf (emphasis added).

[26] The SEC should also carefully avoid **undertaking** a cost-benefit analysis, or any similar approach in which agencies determine and quantify costs and benefits, net them against one another, and adopt the least costly rule. Rather, the SEC should, in explaining its statutory duty under Sections 3(f) and 23(a)(2), explicitly assert that it is not required to perform a cost-benefit analysis, quantify or compare costs and benefits, or perform any analysis that exceeds the Sections 3(f) and 23(a)(2)'s requirements. *See* REPORT, *supra* note 20, at 67-68.

CONCLUSION

We hope these comments are helpful as the SEC develops its approach to cross-border regulation.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen Hall
Securities Specialist

David Frenk
Research Director

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

dkelleher@bettermarkets.com
shall@bettermarkets.com
dfrenk@bettermarkets.com

www.bettermarkets.com

Cc: Chairman Mary Jo White
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