By Electronic Submission

October 7, 2022

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination From the Financial Services Agency of Japan; 87 Fed. Reg. 48,092 (Aug. 8, 2022)

Dear Mr. Kirkpatrick:

Better Markets[1] appreciates the opportunity to comment on the above-captioned proposed order and request for comment ("Order" or "Release") released by the Commodities Futures Trading Commission ("CFTC" or "Commission").[2]

The Financial Services Agency ("FSA") of Japan has requested a determination that its capital and financial reporting requirements applicable to nonbank swap dealers ("SDs") domiciled in Japan are comparable to the capital and financial reporting requirements applicable to nonbank SDs under the Commodities Exchange Act ("CEA"). Such a determination would allow those Japanese SDs to comply with the capital and reporting requirements under the CEA through compliance with the claimed corresponding requirements under Japanese law. The request covers a wide range of critical financial protection requirements, including those relating to regulatory objectives, qualifying and minimum capital, financial reporting, notices, and supervision and enforcement. In the Release, the Commission proposes to issue the comparability determination order, subject to an extensive array of conditions.

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

2 Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination From the Financial Services Agency of Japan, 87 Fed. Reg. 48,092 (Aug. 8, 2022).

In reaching its proposed comparability determination, the Commission used a "principles-based, holistic approach that focuses on whether the applicable foreign jurisdiction's capital and financial reporting requirements achieve **comparable outcomes** to the corresponding CFTC requirements."[3] As a threshold matter, this approach is insufficiently rigorous, leaving far too much room for inaccurate and unwarranted comparability determinations. However, even under this vague and inherently speculative test, it is clear that the FSA capital and financial reporting requirements for nonbank SDs do **not** satisfy the test for an order of substituted compliance because the FSA regulatory framework governing capital and financial reporting is not comparable to U.S. requirements. This conclusion is supported by the CFTC's proposed imposition of numerous significant conditions that it has deemed necessary to compensate for the acknowledged obvious gaps in the FSA framework. If the Commission is nevertheless inclined to grant the comparability order, notwithstanding its conflict with the letter and spirit of the law, it must, at a minimum, ensure that the conditions set forth in the Release are applied and enforced with full force and without exception or dilution.

We understand and appreciate that the Commission has a long history of cooperation with the FSA, as reflected in a memorandum of cooperation. But the financial stability stakes are especially high here, and a positive regulatory rapport with another country is no substitute for strong substantive regulation and oversight of the international and risk-laden swaps markets.

Notably at issue are the **capital** requirements applicable to nonbank SDs, perhaps the single most important pillar among the financial reforms adopted in the aftermath of the 2008 financial crisis. The adequacy of those capital requirements, both in the U.S. and in other countries, is critical to preventing another crisis like the one that engulfed the U.S. and the world just a decade and a half ago. Moreover, this is the first time the Commission is formally applying its substituted compliance framework to the capital rules. Setting the right precedent, one that ensures the application of robust capital requirements to foreign SDs, is essential and vital to the protection of the American people.

Below, we detail these issues, and we also set forth some general principles that must guide the Commission as it evaluates this request for a substituted compliance order and other requests in the future.

BACKGROUND

The 2008 financial crisis ("2008 Financial Crisis") was catastrophic for our financial markets, our economy, and tens of millions of American families. In monetary terms, it destroyed more than $20 trillion in GDP.[4] And the human toll resulting from millions of home foreclosures, deep and prolonged unemployment and underemployment, and massive loss of wealth is

[3] Release at 48,093.

[4] *See* Better Markets, *The Cost of the Crisis: $20 Trillion and Counting* (2015), https://www.bettermarkets.org/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis_1.pdf.

incalculable, and it continues to be felt today. Moreover, on top of the damage caused by the deep recession, as much as $29 trillion was lent, spent, pledged, committed, loaned, guaranteed, and otherwise used or made available to bailout the financial system during the crisis.

One of the key factors that led to and exacerbated the crisis was regulatory arbitrage, both within the United States as between multiple financial regulatory agencies, and as most relevant here, across international borders. Foreign financial services firms were key actors during the financial crisis, engaging in high-risk activities, suffering existential instability, and ultimately requiring massive bailouts at the expense of U.S. taxpayers. In fact, fully nine of the top 20 largest users of the Federal Reserve's emergency lending facilities were foreign entities. Moreover, of the top 16 beneficiaries of the AIG bailout, which paid its counterparties 100 cents on the dollar, ten were foreign.[5] Thus, weak regulation of foreign swap dealers can have dire consequences here in the U.S. This backdrop highlights the importance of the comparability determination, as this proposed Order would apply to Japanese affiliates of Bank of America, Morgan Stanley, and Goldman Sachs—three systemically important institutions and three of the largest TARP recipients having collectively received $60 billion in TARP capital injections.[6]

The financial crisis clearly demonstrated that U.S. regulators had for too long permitted financial intermediaries either to remain dramatically undercapitalized or to structure legal entities and activities to avoid the effective application of capital requirements. In response,[7] Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which included comprehensive and critical reforms to the oversight of the derivative markets. Specifically, Section 4s(e) mandated that SDs and major swap participants ("MSPs") meet minimum capital requirements and uncleared swap margin requirements adopted by their prudential regulator. Similarly, Section 4s(e) mandated that SDs and MSPs without a prudential regulator meet the minimum capital and uncleared swap margin requirements adopted by the CFTC.[8] The CFTC finalized its regulations imposing initial and variation margin obligations on

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5 Better Markets Comment Letter at 3, Prudential Standards for Large Foreign Banking Organizations; Revisions to Proposed Prudential Standards for Large Domestic Bank Holding Companies and Savings and Loan Holding Companies, 84 Fed. Reg. 59,032 (Nov. 01, 2019).

6 Release at 48,117.

7 *See* Statement of Sen. Christopher Dodd, Cong. Rec., Vol. 156, Issue 104, S5828, S5832 (July 14, 2010) ("Derivatives are vitally important if utilized properly in terms of wealth creation and growing an economy. But what was once a way for companies to hedge against sudden price shocks has become a profit center in and of itself, and it can be a dangerous one as well, when dealers and other large market participants don't hold enough capital to back up their risky bets and regulators don't have information about where the risks lie"), available at https://www.congress.gov/111/crec/2010/07/14/CREC-2010-07-14-pt1-PgS5828.pdf. *See also* Statement of Sen. Carl Levin, *Id.* at S5842 ("[The Dodd-Frank Act] will bring new transparency and accountability to the shadowy market in derivatives…It empowers regulators to establish tough new capital requirements that make it harder for firms to become so big they endanger the stability of the system").

8 7 U.S.C. § 6s(e)(2)(B)(i) (providing that "[t]he Commission shall adopt rules for [SDs] and [MSPs], with respect to their activities as a [SD] or [MSP], for which there is not a prudential regulator

nonbank SDs and MSPs for uncleared swaps in 2016[9] and their regulations imposing capital requirements for nonbank SDs and MSPs in 2020.[10]

Reporting requirements were another important component of the reforms governing the swaps markets. They critically give regulators the necessary insight into the condition of market participants, allowing them to address weaknesses and problems and potentially head off potentially catastrophic failures. Section 4s(f) of the CEA mandated that all SDs and MSPs meet reporting obligations imposed by the CFTC.[11] The CFTC finalized its regulations imposing financial condition reporting requirements for SDs and MSPs in 2020 as part of the CFTC's capital requirements rulemaking mentioned earlier.[12]

COMMENTS

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

Better Markets has repeatedly identified serious deficiencies in the "substituted compliance" approach to cross-border regulation that relies on a "regulatory outcomes" test.[13] Those deficiencies are present here, as the Commission expressly relied on the "regulatory outcomes" approach. However, although the CFTC has opted for a suboptimal framework to address cross-border issues, it can, and must, still apply that framework in a manner designed to protect the U.S. financial system as required by the letter and spirit of the law. That is, after all, the fundamental purpose of the Dodd-Frank Act. The CFTC must do this by carefully examining foreign regulatory requirements to ensure that they protect the U.S. financial system in substance, form, over time, and as enforced. Below we review the general principles that should guide the CFTC as it considers the current application for substituted compliance, as well as others in the future.

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imposing—capital requirements"); *see also* 7 U.S.C. § 6s(e)(1)(B) (requiring SDs and MSPs to comply with such requirements).

9 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

10 Capital Requirements of Swap Dealers and Major Swap Participants, 85 Fed. Reg. 57,462 (Sept. 15, 2020).

11 7 U.S.C.§ 6(f) (requiring all SDs and MSPs, including nonbank and bank SDs and MSPs alike to file financial condition reports.

12 Capital Requirements of Swap Dealers and Major Swap Participants, 85 Fed. Reg. 57,462 (Sept. 15, 2020).

13 *See* Better Markets Comment Letter at 25-26, Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Majority Security-Based Swaps Participants and Capital Requirements for Broker-Dealers, 83 Fed. Reg. 53,007 (Oct. 19, 2018) ("The Commission must abandon the regulatory outcomes test and must ensure that the foreign regulation is comparable in substance, form, over time, and as enforced").

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

Congress passed the Dodd-Frank Act to, among other things, "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' [and] to protect the American taxpayer by ending bailouts."[14] All of the CFTC's actions, including analyzing substituted compliance applications and granting substituted compliance requests, must serve and not undermine those goals. This is a critical point because far too often regulators ignore or lose sight of the fact that Congress has explicitly instructed them to protect the financial system, and they instead prioritize other goals.[15] Not only is this flawed from a policy perspective, but prioritizing other goals, such as reducing costs or burdens for the industry while ignoring or minimizing the actual goals Congress directed the CFTC to consider, is plainly unlawful.[16]

Put simply, if there is tension between the statutorily-mandated goal of protecting the American financial system on the one hand, and serving some other goal on the other hand (like comity among regulators or countries), the former must prevail. The CFTC simply cannot, as a matter of law or policy, subordinate Congress's will to other goals, no matter how important the CFTC believes those other goals may be. Accordingly, before the CFTC grants substituted compliance to reduce burdens for the industry, provide certainty, or promote international comity, it must first and foremost make a determination that granting substituted compliance complies with the law and promotes the protection of the American financial system.

This overriding policy objective applies with special force to capital requirements. In amending the CEA after the 2008 Financial Crisis pursuant to the Dodd-Frank Act, Congress issued the CFTC a clear mandate for instituting capital requirements for SDs and MSPs. Section 4s(e)(3) specifies that one statutory objective of imposing capital requirements is "[t]o offset the greater risk to the [SD] and [MSP] and the financial system arising from the use of swaps that are not cleared," and in this regard, it requires capital levels that (1) "help to ensure the safety and soundness of the [SD] and [MSP];"[17] and (2) are "appropriate for the risk associated with the non-

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

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

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

17 7 U.S.C. § 6s(e)(3)(A)(i).

cleared swaps held as a [SD] or [MSP]."[18] Thus, any substituted compliance order issued by the CFTC to a foreign jurisdiction relating to capital requirements must give special attention to this statutory mandate and objective.

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

While the CFTC has unwisely rejected a more substantive, objective, and precise "line-by-line"[19] assessment or comparison in favor of a broader, ill-defined, and difficult to apply focus on "regulatory outcomes," the reality is that the best way to have confidence that a foreign jurisdiction's regulatory regime will produce substantially equivalent outcomes is to ensure that the relevant jurisdiction has substantially similar binding legal requirements. Simply put, it is difficult to imagine many cases where materially different legal requirements produce substantially similar "regulatory outcomes."

Nevertheless, if the CFTC is going to grant substituted compliance with regard to materially different regulatory requirements, the CFTC must make a well-supported, evidence-based determination that those different requirements nevertheless will, in fact, lead to comparable regulatory outcomes. At a minimum, this would require the CFTC to clearly and specifically articulate the desired regulatory outcome and provide a detailed, evidence-based explanation as to how the jurisdiction's different legal requirements nonetheless lead to that regulatory outcome.

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

A determination that a foreign jurisdiction's nonbank SDs rules would produce comparable regulatory outcomes is the beginning, not the end, of the CFTC's obligation to ensure that the activities of foreign nonbank SD entities do not pose risks to the U.S. financial system. As time goes on, regulatory requirements that, in theory, are expected to produce one regulatory outcome may, in practice, produce a different one. And, of course, the regulatory requirements may themselves be changed in a variety of ways. Finally, the effectiveness of an authority's supervision and enforcement program can become weakened for any number of reasons—the CFTC cannot assume that an enforcement program that is presently effective will continue to be effective.

Accordingly, to fulfill its statutory obligation to protect the U.S. financial system, the CFTC must ensure, on an ongoing basis, that each grant of substituted compliance remains appropriate over time. At the very least, this would require that each order granting substituted compliance, and each memorandum of understanding with a foreign regulatory authority, impose an obligation that the applicant, as appropriate:

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18 7 U.S.C. § 6s(e)(3)(A)(ii).

19 Release at 48,105.

(1) Periodically apprise the CFTC of the activities and results of its supervision and enforcement programs, to ensure that they remain sufficiently robust to deter and address violations of the law; and

(2) To immediately apprise the CFTC of any material changes to the regulatory regime, whether explicit (i.e. rule changes) or implicit (i.e. changes in how a rule is interpreted, applied, or enforced).

II. THE RELEASE IS INADEQUATE TO SUPPORT A DETERMINATION OF CAPITAL AND FINANCIAL REPORTING COMPARABILITY BECAUSE IT LACKS SUFFICIENT ANALYSIS AND ACTUALLY LOWERS EXISTING CAPITAL REQUIREMENTS FOR JAPAN NONBANK SD'S.

The Release does not provide adequate support for an affirmative determination of comparability between the U.S. and Japanese capital and financial reporting regimes. In fact, based upon the current record, the capital and financial reporting requirements adopted in Japan do **not** appear comparable to those under the CEA. The Release identifies and acknowledges some of the key differences between the U.S. and Japanese regulatory regimes, but it relies too much on conclusionary statements that the two regimes are nevertheless comparable without disclosing sufficient facts, data, or analysis to support those claims. Absent further disclosure, specifically relating to the treatment of capital between the two regimes, the Proposed Order cannot be granted consistent with the law.

A. The capital requirements are not comparable.

As the Release notes, the capital requirements for nonbank SDs in Japan are significantly different from those adopted by the CFTC for U.S. SD entities. While the CFTC's Bank-Based Capital Approach and Japan's capital rules for nonbank SDs are both based on the Basel framework for bank capital, there are important differences. These differences are manifested in the different definitions of capital adopted by the two regulatory regimes, as well as their different approaches to ensuring adequate levels of capital based on risk. For example, whereas the CFTC relies on an approach that requires nonbank SDs to "hold qualifying capital in amount equal to at least 8 percent of the nonbank SD's uncleared swap margin amount" (which is based on the risk profile of the swap positions and is similar in concept to risk-weighted assets in the capital framework), Japan's capital rules are based on an arbitrary percentage of a company's operating expenses, which would be closer in concept to liquidity needs.[20] The result is that not only are Japan's capital rules different from the CFTC capital rules in both form and substance, but the regulatory outcome is not comparable.

The Release relies in part on the fact that the CFTC and Japanese capital requirements for nonbank SDs are both consistent with the Basel framework. By way of explanation, the CFTC capital rules for nonbank SDs allow for three separate capital approaches: the Tangible Net Worth

[20] Release at 48,106.

Approach, the Net Liquid Assets Capital Approach, or the Bank-Based Capital Approach.[21] The Bank-Based Capital Approach is based on capital requirements set by the Federal Reserve Board of Governors for bank holding companies and is also consistent with the Basel Committee on Banking Supervision's international ("Basel") framework for capital.[22] For purposes of analyzing Japan's capital requirements for nonbank SDs, the CFTC compares the Japan regulatory regime with the CFTC's Bank-Based Capital Approach because the Japanese requirements are also based on the Basel framework, and all existing Japanese nonbank SDs are "subject to the current bank-based capital approach of the Japanese Capital Rules."[23]

However, the Release rightfully notes that just because a foreign jurisdiction's regulatory regime is "consistent" with the Basel framework, it does not follow that it is "comparable" to the CFTC capital rules "without an assessment of the individual elements of the foreign jurisdiction's capital framework."[24] Therefore, CFTC correctly concludes that an assessment of each individual element of the foreign jurisdiction's capital framework is necessary before a determination of comparability between the CFTC's capital rules and Japan's capital rules can be made. Below, we have highlighted in more detail individual elements of Japan's capital rules that differ from the CFTC's capital rules and that require more analysis by the CFTC to make a determination of capital comparability.

Comparison of Qualifying Capital

The CFTC capital rules for the Bank-Based Capital Approach require nonbank SDs to "maintain regulatory capital in the form of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital."[25] This stands in contrast with the Japanese capital rules for nonbank SDs, which require nonbank SDs to maintain a "capital adequacy amount" in the form of "Basic Items and Supplemental Items."[26] Moreover, the Japanese framework establishes no dollar minimum capital requirement.

While the Release lists the elements for each form of capital in both the U.S. and Japanese capital rules (i.e., what makes up common equity tier 1, Basic Items, tier 2, etc.), it does not adequately analyze the differences between the two regulatory regimes. Instead, the Release summarily states that "the types and characteristics of the equity instruments included in Basic Items under the Japanese Capital Rules are comparable to the types and characteristics of equity instruments comprising common equity tier 1 capital and additional tier 1 capital." It similarly declares that the "Supplemental Items under Japanese Capital Rules are also comparable to tier 2 capital."[27]

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21 17 CFR 23.101.
22 Release at 48,096.
23 Release at 48,098.
24 Release at 48,098.
25 Release at 48,100.
26 Release at 48,100.
27 Release at 48,101.

These conclusionary and unsupported statements are made despite the differences listed in the Release. For example, Basic Items under the Japanese capital rules include "treasury stock."[28] However, under the CFTC capital rules, which are based on definitions of capital from the Federal Reserve Board, common equity tier 1 capital is "net of treasury stock."[29] Despite this difference in the definitions of the highest form of capital, the Release is silent on whether or not the CFTC identified or analyzed how this distinction effects capital or how that distinction may or may not effect a comparability determination.

Additionally, one of the elements of the CFTC Bank-Based Capital Approach is that nonbank SDs must maintain "an amount of common equity tier 1 capital of at least $20 million."[30] In stark contrast, **Japan does not have this base level capital requirement**. This, on its face, demonstrates a fatal lack of comparability. To compensate for this gap, one of the conditions set forth in the Release is for nonbank SDs in Japan to "maintain a minimum level of regulatory capital in the form of Basic Items" of at least $20 million.[31]

However, that attempted compensation is still inadequate because the capital requirement applicable to Japan's nonbank SDs under the proposed order would still be materially weaker than the level applicable under the CFTC's framework. As previously quoted above, the Release found Japan's Basic Items to be equivalent to the combination of the CFTC's common equity tier 1 capital and additional tier 1 capital. This means that the Release is proposing that Japan nonbank SDs must hold $20 million in capital equivalent to the U.S.'s common equity tier 1 capital in combination with additional tier 1 capital, while U.S. nonbank SDs must hold $20 million exclusively in the higher form of common equity tier 1 capital. Because the Release does not explain the basis for allowing the Japan nonbank SDs to adhere to a lower capital standard than that which is applicable to U.S. nonbanks, it cannot be determined to be comparable.

A well-known, longstanding foundational principle of capital regulation reflected in the law requires both the quantity **and** quality of capital to meet minimum criteria. If either are missing or inadequate, then the regimes cannot be comparable and, therefore, do not comply with the law.

Treatment of Risk Adjusted Assets

The CFTC capital rules for the Bank-Based Capital Approach require nonbank SDs to maintain "an aggregate of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital equal to or greater than 8 percent of the nonbank SD's total risk-weighted assets, **provided that common equity tier 1 capital comprises at least 6.5 percent of the 8 percent**."[32] In contrast, the Japanese capital rules require nonbank SDs to hold enough **capital equal to or greater than 120 percent of its risk-weighted assets, including 50 percent that must be held in Basic Items**.[33]

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28 Release at 48,100.
29 12 CFR 217.20.
30 Release at 48,101.
31 Release at 48,106.
32 Release at 48,101 (emphasis added).
33 Release at 48,097.

The Release states that this equates to "an effective minimum capital requirement of 9.6 percent of its risk-weighted assets."[34] However, the Release does not provide its analysis of how it calculated this effective minimum, nor more importantly, does it disclose how much of the 9.6 percent is held in Basic Items as opposed to Supplementary Items. Without this information and analysis, no comparability determination can be made because U.S. nonbank SDs are required to maintain 6.5 percent of the total 8 percent of risk-weighted assets in the highest form of capital—common equity tier 1 capital. Again, both the quantity and quality of capital must be determined before any comparability conclusions can be drawn. Additionally, as noted previously, even with this disclosure, U.S. nonbank SDs will be held to a higher capital standard than Japan nonbank SDs because Japan's Basic Items include common equity tier 1 capital **along with** additional tier 1 capital.

The foregoing analysis illustrates two related problems with the Commission's comparability analysis: The U.S. and Japanese approaches to nonbank SD capital requirements differ in material respects, and the Release fails adequately to explain how the Commission justifies its conclusion that they are comparable notwithstanding these material differences.

B. The financial reporting requirements are not comparable.

Despite a number of material differences highlighted in the Release between the U.S. and Japan reporting requirements for nonbank SDs, the CFTC preliminarily determines that the reporting requirements are comparable, subject to a number of conditions. First, the Release conditions a determination of comparability on Japanese nonbank SDs submitting copies of their Monthly Monitoring Reports, Annual Business Reports, and Annual Audited Financial Reports.[35] While one part of the Release states the financial reports submitted to the FSA by Japanese nonbank SDs are comparable to the financial reports submitted to the CFTC by U.S. nonbank SDs, the Release fails to support its conclusion that the form and contents of the Japanese reports are comparable to U.S. reporting requirements.

The Release also conditions a determination of comparability for Japanese nonbank SDs on a requirement that Japanese nonbank SDs submit a statement—in lieu of an oath or affirmation required of U.S. nonbank SDs—from an authorized representative of the company that "to the best knowledge and belief of the persons(s) the information contained in the respective report is true and correct."[36] While this is an important condition as far as it goes, it highlights a major and critically important difference between the regulatory reporting requirements of the U.S. and those of Japan. There are significant legal differences between submitting a "statement" as Japanese nonbank SDs would have to do under this condition and the existing requirement for U.S. nonbank SDs that must submit an oath or affirmation. The Release fails to address, explain, or explore this facially significant distinction.

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34 Release at 48,104, note 125.
35 Release at 48,108.
36 Release at 48,108-48,109.

While the CFTC proposes an extensive array of conditions on the determination of comparability with respect to reporting obligations, it takes a hands-off approach to the review of risk models and related reporting. The Release proposes that the CFTC does not need to review, monitor, or approve of the internal models used by Japanese nonbank SDs to measure risk exposure. Moreover, the Release specifically states that "[t]he Commission is not proposing to require a Japanese nonbank SD that has been approved by FSA to use capital models to file monthly model metric information contained in Regulation 23.105(k)."[37] While the U.S. allows nonbank SDs to utilize internal models to calculate risk exposure, the CFTC must approve the use of such internal models. Thus, with respect to the internal models used by Japanese nonbank SDs to measure their risk exposures, the CFTC is proposing to take a back seat to the FSA and blindly accept the assessments resulting from their use of internal models to calculate risk.[38] This lack of a condition regarding risk models undercuts the notion that the two reporting and risk assessment regimes could be regarded as comparable even with the provisos set forth in the proposed Order. At a minimum, the proposed Order should be amended to require the submission by the Japanese nonbank SDs of risk model metric information to the CFTC.

III. THE EXTENSIVE ARRAY OF CONDITIONS INCLUDED IN THE PROPOSED ORDER BELIES COMPARABILITY AND IMPOSES ADDITIONAL BURDENS ON THE CFTC AS WELL AS THE FSA, YET THOSE CONDITIONS ARE ESSENTIAL IF THE COMMISSION INSISTS ON FINALIZING THE PROPOSED ORDER.

The differences between the capital and financial reporting regimes applicable to nonbank SDs in Japan and the U.S., explained above, mandate denial of Japan's request for a comparability determination. However, instead of simply denying substituted compliance as the law would appear to require, the CFTC proposes to establish a set of conditions presumably intended to ensure that the two regimes **become** comparable. These approaches implicitly concede that the two regimes are not currently comparable. It furthermore raises the question of why substituted compliance is being granted if the CFTC has determined that no less than 22 discrete conditions

37 Release at 48,109.

38 The failure of internal risk models was one of the key failings identified in the aftermath of the 2008 Financial Crash, which is why there are approval requirements like the one imposed by the CFTC here. *See* Financial Crisis Inquiry Commission Report 65 (2011) ("Because investment banks were not subject to the same capital requirements as commercial and retail banks, they were given greater latitude to rely on their internal risk models in determining capital requirements, and they reported higher leverage. At Goldman Sachs, leverage increased from 17:1 in 2000 to 32:1 in 2007. Morgan Stanley and Lehman increased about 67% and 22%, respectively, and both reached 40:1 by the end of 2007); *see also* Richard Spillenkothen, *Notes on the performance of prudential supervision in the years preceding the financial crisis by a former director of banking supervision and regulation at the Federal Reserve Board* (1991 to 2006) 12, (May 31, 2010) ("major regulatory and supervisory policy mistakes included…[a]cceptance of Basel II premises…comprising an excessive faith in internal bank risk models, an infatuation with the specious accuracy of complex quantitative risk management techniques, and a willingness (at lease in the early days of Basel II) to tolerate a reduction in regulatory capital in return for the prospect of better risk management and greater risk-sensitivity").

are required to accomplish comparability. Granting substituted compliance with multiple conditions intended to mimic the CFTC's capital and reporting requirements would seem to undermine the entire point of substituted compliance in the first place—protecting the stability of the U.S. financial system by allowing substituted compliance **only when** foreign regimes are comparable.

This approach is suboptimal and undesirable for other reasons as well. Essentially, the CFTC is layering another set of capital and reporting requirements that Japanese nonbank SDs will have to abide by, exacerbating complexity and adding to market fragmentation. In addition, the CFTC, by essentially crafting a new set of rules ostensibly for the benefit of Japan nonbank SDs, is committing to the assumption of additional regulatory burdens. The CFTC will have to monitor compliance with all of the conditions, including reviewing the financial reports of Japanese nonbank SDs and tracking developments in the FSA regulatory regime more generally.

This in turn raises the concern that the CFTC may in the future be inclined to drop or dilute some of the requirements rather than rescind the grant of substituted compliance, if the CFTC and the FSA are met with resistance from firms in Japan facing the associated compliance costs and burdens. For this reason as well, the CFTC should simply deny the petition for a comparability order and apply the full array of U.S. requirements to nonbank SDs domiciled in Japan. The burden would then fall on the FSA, as it should, to raise its standards governing nonbank SDs activities, so that the requirements and outcomes under its regime are truly comparable to those produced under U.S. law.

Finally, we emphasize that if the CFTC proceeds to finalize the comparability order notwithstanding the law and the underlying policy objectives, then it must at least ensure that the conditions are robustly maintained and enforced. These conditions, supplemented as argued above, are more than mere enhancements or adjustments to an otherwise comparable regime; they are essential, the **bare minimum** that the CFTC must establish, that the nonbank SDs in Japan must follow, and that the FSA must enforce over time.

The CFTC **absolutely must not weaken or eliminate these essential conditions** in response to comments by the industry, which is primarily concerned with reducing its own operational costs without adequate regard for the systemic risk that doing so would pose. Any determination to find Japan's capital rules comparable to the CFTC's capital rules without conditions at least as strong as proposed (and enhanced) would not only contravene the agency's own conception of substituted compliance but expose the U.S. financial system to the very risks the Dodd-Frank Act instructed the CFTC to contain.

CONCLUSION

We hope these comments are helpful as the Commission finalizes its response to the FSA's request for a comparability determination.

Sincerely,

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