BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

August 21, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rule and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants (Release No. 34-69490; File Nos. S7-02-13; S7-34-10; S7-40-11)

Dear Ms. Murphy:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules and interpretive guidance ("Proposal" or "Release"), which were issued pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The Proposal addresses the crucial application of Title VII, and the SEC's implementing regulations thereunder, to the cross-border activities of U.S. and non-U.S. market participants engaged in security-based swap ("SBS") transactions.

INTRODUCTION

Counterparty credit risk—and by extension, systemic risk—knows no international boundaries. Consequently, the U.S. regime for regulating derivatives, which is designed to protect taxpayers from ever again having to bail out the global financial system, will fail unless it is applied not only domestically but also to cross-border transactions.

The danger of not effectively regulating cross-border SBS activity is vividly illustrated in the collapse, near-collapse, and massive losses experienced by innumerable banks engaged in derivatives trading across international boundaries. These examples are found not only in the lead-up to the financial crisis of 2008, but in much more recent history as well.

[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.

Moreover, without strong cross-border application of Title VII of the Dodd-Frank Act, U.S. corporations will simply move, often with no more than a keystroke, their SBS operations overseas to avoid regulation. However, the enormous risks inherent in derivatives activity will remain in the U.S. and when trading strategies fail miserably and generate huge losses, those losses will come directly back to the U.S., almost certainly resulting in more costly bailouts. Thus, the upside of derivatives trading—from jobs to profits—goes overseas, while the downside remains with the American taxpayer. This is an ideal outcome if you are a bank or a foreign country, but it is potentially disastrous for the U.S. and its taxpayers. The SEC must use its authority to regulate cross-border SBS activity to the maximum extent possible to prevent these outcomes.

In this comment letter, we focus on the following issues relating to the SEC's Proposal:

- The scope of the SEC's cross-border authority, under both its territorial jurisdiction and its power to prevent evasion of the Title VII framework;
- The SEC's overall approach in the Proposal, which is far too long, convoluted, and confusing, creating a host of problems ranging from loopholes to implementation and enforcement challenges;
- The substantive approach to cross-border regulation in the Proposal, which incorporates too many exceptions, inconsistencies, and other flaws, resulting in a weak cross-border framework;
- The importance of robust cross-border regulation, highlighting the extraordinarily interconnected nature of the global derivatives market, the many examples of the risks to the U.S. posed by international derivatives activity, and the dangers associated with delay or reliance on foreign regulation; and
- The SEC's economic analysis, which goes far beyond what the securities laws actually require of the SEC when it promulgates rules.

SUMMARY OF COMMENTS

The SEC has extensive authority to regulate cross-border activity and a duty to do so. The Commission's statutory duty is to apply Title VII not only to entities within the jurisdiction of the U.S., but also as necessary or appropriate to prevent evasion of Title VII, wherever it may occur. The Commission should maximize the effectiveness of its cross-border regulation, and where possible given that approach, seek to promote harmony with the Commodity Futures Trading Commission's ("CFTC") recently issued cross-border guidance.

The Release is too long, convoluted, and unclear. Consequentially, it discourages meaningful comment, virtually guarantees that cross-border regulation will be riddled with loopholes, and will prove very difficult for the SEC to implement, oversee, and enforce. To remedy these problems, the SEC must streamline and strengthen the content of the Proposal, and, in particular, simplify and strengthen the concept of substituted compliance.

The SEC's definition of "U.S. person" is too narrow, as it excludes guaranteed affiliates and other entities so connected with U.S. persons that they are effectively U.S. persons. As the Proposal correctly recognizes, a foreign branch of a U.S. person is part of that U.S. person and not a separate entity. However, unlimited liability entities that are majority-owned by a U.S. person(s) and collective investment vehicles that are majority-owned by a U.S. person(s) are also U.S. persons, regardless of whether they are organized or incorporated in the United States. In addition, guaranteed affiliates and effectively guaranteed affiliates of U.S. persons must be treated as U.S. persons.

The SBS Dealer *de minimis* calculation is under-inclusive, excluding many SBS transactions that should be counted when determining dealer status. Transactions with non-U.S. persons that receive guarantees from U.S. persons, as well as transactions with foreign branches of U.S. banks must be included in the *de minimis* calculation.

Distinguishing between entity-level and transaction-level requirements is appropriate, but the treatment and applicability of certain requirements must be changed. The SEC's general distinction between entity-level and transaction-level requirements is valid. However, the SEC should treat margin as a transaction-level requirement to minimize the application of substituted compliance to that critical regulatory safeguard. Moreover, the exceptions for the mandatory clearing and trade execution requirements are unacceptable. And, the public dissemination requirement under Regulation SBSR must be expanded.

The Proposal does not provide an adequate legal or policy justification for allowing substituted compliance, and if permitted at all, it must be substantially narrowed and subjected to much stronger criteria. The Proposal does not justify the substituted compliance approach. If the SEC nevertheless adopts such an approach, substituted compliance should not be allowed in transactions with U.S. persons or transactions occurring within the United States. In particular, substituted compliance should not be permitted as to External Business Conduct Standards for transactions with U.S. persons. Further, substituted compliance should not be available as to Major SBS Participants without reliable and comprehensive data showing that it is prudent to permit.

In addition, even where permitted, substituted compliance should be subject to more rigorous tests and a more public process. The SEC must abandon the regulatory outcomes test and must ensure that the foreign regulation is comparable in substance, form, over time, and as enforced. The SEC should not simply outsource the protection of U.S. taxpayers to EU bank regulators, which badly failed foreign depositors, taxpayers, and treasuries. Finally, the process for making a substituted compliance determination must be more transparent.

Cross-border derivatives activity poses major risks to U.S. markets, and it must be aggressively regulated under Title VII without delay so that those risks can be detected, minimized, and contained. The derivatives market is highly global and interconnected. And, history has repeatedly illustrated the high levels of risk that derivatives markets can generate and transfer across international boundaries. Moreover, the Proposal must be finalized quickly. Any delay or weakening of the rules in anticipation of strong foreign regulation is unwarranted. Neither international harmony nor principles of comity can justify delay, and foreign regulators are years away from implementing comprehensive derivatives regulation.

Lastly, as it finalizes the Proposal, the Commission should adhere to a number of core principles governing the economic analysis actually required under the securities laws.

- Under the securities laws, the Commission has no statutory duty to conduct cost-benefit analysis; its far more narrow obligation is to consider the congressionally enumerated factors.
- The Commission must be guided first and foremost by the public interest and the protection of investors as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry.
- For any rule promulgated in accordance with and in furtherance of the Dodd-Frank Act, the ultimate public interest and investor protection consideration is implementing the reforms that Congress passed to provide for a safer and sounder financial system and to prevent another financial crisis.
- The Commission must ensure that its economic analysis is limited to its narrow duty under Sections 3(f) and 23(a)(2) and that it does not undertake an onerous cost-benefit analysis.
- Finally, wherever applicable, the Commission should explicitly set forth the fact that the rule is being proposed or adopted as part of a comprehensive, integrated framework aimed at preventing another financial crisis.

COMMENTS

I. The SEC has extensive authority to regulate cross-border activity and a duty to do so.

The SEC has extensive authority over cross-border SBS transactions, based upon its territorial jurisdiction and its anti-evasion powers. Both the law and common sense dictate that if an SBS transaction falls within the jurisdiction of the United States—properly interpreted to encompass transactions that are conducted, in whole or in part, within the U.S.—or if the transaction could be used to evade U.S. regulation, it must be regulated in accordance with the standards of the Dodd-Frank Act. The SEC must use all of this authority to the maximum extent possible to achieve the underlying goals of Title VII of the Dodd-Frank Act: to effectively monitor, contain, and manage the risks to the U.S. financial system arising from derivatives transactions.

A. The Commission's statutory duty is to apply Title VII not only to entities within the jurisdiction of the U.S., but also as necessary or appropriate to prevent evasion of Title VII, wherever it may occur.

The scope of the SEC's authority under Title VII is delineated in Section 772(b) of the Dodd-Frank Act, which amended Section 30(c) of the Exchange Act to provide:

> No provision of . . . [the Dodd-Frank Act], or any rule or regulation thereunder, shall apply to any person insofar as such person transacts a business in security-based swaps without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of any provision of . . . [the Dodd-Frank Act]. [2]

Thus, Title VII applies to any person transacting a business in SBS within the jurisdiction of the U.S. **and** to any person without the jurisdiction of the U.S. as the SEC determines necessary or appropriate to prevent evasion of Title VII.

Both of these jurisdictional tests can and must be applied broadly to ensure that the Title VII framework is not rendered largely meaningless by overseas SBS activity. Consistent with Supreme Court precedent,[3] persons transacting SBS business on domestic platforms **or** persons transacting SBS business where any aspect occurs within the U.S. or with U.S. persons, are within U.S. jurisdiction.

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2 15 U.S.C. § 78dd(c).

3 *Cf. Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2888 (2010) (finding U.S. jurisdiction lacking in a case that "involve[d] no securities listed on a domestic exchange, and all aspects of the purchases complained of . . . occurred outside the United States.").

For example, as acknowledged in the Release, transactions can occur within the U.S. simply by virtue of a guarantee: "a transaction entered into by a non-U.S. person whose performance under the security-based swap is guaranteed by a U.S. person is within the United States by virtue of the involvement of the U.S. guarantor."[4] Thus, even under the "territorial" test for SEC jurisdiction, a broad range of SBS transactions can be subjected to regulation, including those that are negotiated or traded overseas but involve a U.S. guarantor.

Moreover, to protect the American taxpayer, economy, and financial system, the SEC can and must also interpret its anti-evasion authority broadly to encompass certain persons who are "without" the jurisdiction of the U.S. As the Release correctly points out, "Section 30(c) does not require the Commission to find actual evasion," nor does it "require that every particular application of Title VII to security-based swap activity 'without the jurisdiction of the United States' address only business that is transacted in a way that evades Title VII."[5] Rather, the SEC's anti-evasion authority is broad: "Section 30(c) permits the Commission to impose prophylactic rules intended to prevent possible evasion, even if they affect both evasive and non-evasive conduct."[6]

Unfortunately, as discussed in greater detail below, while the SEC acknowledges the breadth of its jurisdiction under both the territorial and anti-evasion prongs of Section 30(c), it fails to take full advantage of this authority. As a result, the Proposal will actually facilitate evasion in many respects by often exempting foreign guaranteed affiliates and even branch offices from the scope of direct Title VII regulation, and by deferring to foreign rules based largely on the form of a U.S. entity.

This will almost certainly result in the proliferation of business entities created purely for the purpose of evading regulation of SBS activity under Title VII—thus thoroughly defeating the goals of the law through mere formalities.

B. The Commission should maximize the effectiveness of its cross-border regulation, and where possible given that approach, seek to promote harmony with the CFTC's recently issued cross-border guidance.

As stated above, the SEC's primary responsibility under the Dodd-Frank Act cross-border provisions is to establish effective cross-border regulation of SBS activity using its territorial and anti-evasion authority. At the same time, it should promote harmony with the CFTC's cross-border guidance, subject to its primary duty and recognizing that its statutory authority and jurisdiction is distinct from that of the CFTC.

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4 78 Fed. Reg. 30,987.

5 78 Fed. Reg. 30,987.

6 *Id.; see also* CFTC, Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,299-300 n. 71 (July 26, 2013) ("CFTC Guidance") (noting as further evidence of its (and by extension the SEC's) broad authority the much more restrictive amendments that were proposed but not adopted in the Dodd-Frank Act with respect to cross-border regulation).

On July 12, 2013, the CFTC adopted its own cross-border guidance ("CFTC Guidance").[7] Under, Section 712(a)(2) of the Dodd-Frank Act the SEC is required to "consult and coordinate to the extent possible with the [CFTC] . . . for the purposes of assuring regulatory consistency and comparability, to the extent possible." However, the SEC's obligation to seek consistency and comparability with the CFTC cross-border guidance is limited in several respects. First, the harmonization clause, quoted above, is narrow on its face. It only requires consultation and coordination, not a specific level of harmony between the CFTC and SEC approaches to cross-border regulation. The statutory language makes this clear through repeated, limiting references to the phrase "to the extent possible."

Second, the CFTC and the SEC have very different statutory mandates with respect to cross-border jurisdiction. The CFTC is subject to Section 2(i) of the Commodities Exchange Act, as amended by Section 722(d) of the Dodd-Frank Act. In accordance with that amendment, the CFTC Guidance clarifies that the Title VII swaps provisions apply to U.S. persons and to non-U.S. persons when their activities have a "direct and significant connection with activities in, or effect on, commerce of the United States" or when they contravene regulations that the CFTC finds necessary or appropriate to prevent evasion of Title VII. Although both the SEC's and the CFTC's cross-border authority includes anti-evasion authority, much of the CFTC's focus in the CFTC Guidance is on the application of the CFTC's authority over "direct and significant" swaps activities.

Thus, the SEC should first and foremost apply its territorial and anti-evasion authority in a way that furthers the goals of the Dodd-Frank Act to the greatest possible extent. Within that framework, the SEC should seek to achieve harmony with the CFTC approach. In effect, the SEC should adopt rules that are **at least as strong as the CFTC's guidance**, consistent with its statutory authority, **but should go further** than the CFTC wherever necessary, and again consistent with its statutory authority, to better fulfill the goals of the Dodd-Frank Act.

II. The Release is too long, convoluted, and unclear.

The Proposal suffers from major defects as to form. It is far too long, convoluted, and difficult to comprehend. It is also redundant in many parts and internally inconsistent in others. It contains over 600 single-spaced pages, close to 2,000 footnotes, 31 pages of proposed rule text, and over 1,000 questions. While it attempts to present a thorough treatment of an important subject, what it gains through exhaustive analysis is more than lost through its lack of clarity and disorganization. In short, it does not present a clear and cogent explanation of how the SEC will apply Title VII to cross-border activity and why.

Unfortunately, the complexity and impenetrable nature of the Proposal appears to be due in part to significant, unwarranted, and inappropriate concessions to the

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7 78 Fed. Reg. 45,292 (July 26, 2013).

financial industry. The many exceptions and carve-outs in the Proposal (for foreign branches, for example) arising from this approach have inevitably compromised any hope of making the SEC's proposed framework clear or comprehensible.

Particularly troubling are the fundamental inconsistencies in the Proposal. On numerous important issues, the SEC states the correct principle and then draws the wrong conclusion. For example, the Release repeatedly and correctly sets forth the basic principle that whenever a U.S. person guarantees the trades of a foreign entity, the U.S. financial system remains subject to risk, and in a very real sense, those trades occur at least in part within the jurisdiction of the United States, wherever they may actually be executed. This is precisely the rationale for including guaranteed subsidiaries and other affiliates in the definition of U.S. person, and for including transactions with foreign entities that are guaranteed by U.S. persons within SBS Dealer *de minimis* calculation. Yet, the Proposal nevertheless then fails to adopt these approaches, without valid explanation. Indeed, many of the distinctions and rationales for not adopting a particular approach are arbitrary and capricious, with nothing more than circular or irrelevant arguments purportedly offered to back up the proposed rules.

The elaborate and impenetrable nature of the Proposal represents more than mere inconvenience for those who must read and understand the content. It creates other more significant problems. First, it undermines the rulemaking process by actually discouraging and/or inhibiting meaningful comment. The length, complexity, and impenetrability of the Proposal require an inordinate amount of time to obtain even a minimal understanding of what the SEC proposes to do and how each of the different proposed requirements relate to one another. This makes it nearly impossible for anyone without industry's unlimited time and inexhaustible resources to be able to provide input to the SEC on the Proposal.

Second, the complexity, lack of clarity, and vagueness of the Proposal virtually guarantee that any final rule that is based on it will be riddled with loopholes, ambiguities, and unintended consequences. Many of those problems will not even become apparent until the needlessly complex regime has been in place and studied for some time. Finally, such a Proposal will prove very difficult for the SEC to implement, oversee, and enforce.

To remedy these problems, the SEC must streamline and strengthen the content of the Proposal by removing many of the exemptions, as discussed in greater detail below. In addition and as discussed below, Better Markets urges the Commission to revisit, simplify, and strengthen the concept of substituted compliance and apply Title VII whenever a U.S. person is involved or the transaction occurs within the U.S.

Finally, it is imperative that the Commission do whatever is necessary to organize and present the final Proposal in terms that are concise, clear, and comprehensible. If the SEC fails to do so, it will set up a cross-border regime that will fail and therefore permit or create the very risks that the Dodd Frank Act was designed and intended to address.

III. The SEC's definition of "U.S. person" is too narrow, as it excludes guaranteed affiliates and other entities so connected with U.S. persons that they are effectively U.S. persons.

The bedrock of the entire SEC cross-border regime is the legal concept of "U.S. person." Therefore, it is imperative that the Commission appropriately define "U.S. person" broadly to include **any** overseas entity that is indistinguishable from a U.S. person, either because of its legal form or because of explicit or implicit guarantees that run from a U.S. person to the foreign entity. In particular, "U.S. person" must include any affiliate controlling, controlled by, or under common control with an entity that is headquartered, incorporated, or otherwise residing in the United States, regardless of whether it is wholly or partially owned, and regardless of whether or not there are explicit financial guarantees in place.

A. As the Proposal recognizes, a foreign branch of a U.S. person is part of that U.S. person and not a separate entity.

As the Proposal appropriately recognizes, a foreign branch (or trading desk or office) of a U.S. person is not a separate legal entity of that U.S. person. Rather, it is "merely an extension of the head office," and therefore must be considered a U.S. person for purposes of the cross-border application of Title VII.[8] Counterparties of the foreign branch have direct recourse in bankruptcy to the U.S. person. Moreover, as the CFTC has explained, "branches are neither separately incorporated nor separately capitalized and, more generally, the rights and obligations of a branch are the rights and obligations of its principal entity (and vice versa)."[9]

The nonexistent division between the foreign branch of a U.S. person and that U.S. person was apparent during the crisis, but has been amply illustrated by recent events. Both JP Morgan Chase and UBS recently lost billions of dollars through trades conducted through their foreign branches located in London. JP Morgan Chase, through trades conducted by its London Chief Investment Office, lost $6 billion and over $20 billion in market capitalization.[10] Similarly, in 2011 UBS, a Swiss company, 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]

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8 78 Fed. Reg. 30,997.

9 CFTC Guidance, 78 Fed. Reg. 45,315.

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

11 Jonathan Russell, *UBS rogue trader Kweku Adoboli jailed for seven years*," THE TELEGRAPH, Nov. 20, 2012, *available at* http://www.telegraph.co.uk/finance/financial-crime/9690206/UBS-rogue-trader-Kweku-Adoboli-jailed-for-seven-years.html.

B. A legal entity that is directly or indirectly majority-owned by one or more U.S. persons and in which such person(s) bears unlimited responsibility for the obligations and liabilities of that legal entity is a U.S. person.

With respect to legal entities that are directly or indirectly majority-owned by one or more U.S. persons and in which such person(s) bear unlimited responsibility for the obligations of that legal entity, the SEC must look through to the status of the owners and classify the legal entity itself as a U.S. person. Such an unlimited liability company is undoubtedly a U.S. person and, in any case, must be classified as such for purposes of the cross-border application of Title VII to prevent evasion of U.S. regulation. To do otherwise would enable U.S. persons to achieve indirectly what they could not achieve directly, resulting in the evasion of SEC regulation and oversight. This is of particular concern with respect to the SBS Dealer *de minimis* calculation, because a non-U.S. person, who would otherwise have the same connection with and pose the same risk to the United States, could avoid SBS Dealer registration, and in turn regulation, by limiting any dealing activity above the *de minimis* threshold to these entities.

Moreover, this approach is consistent with the CFTC's cross-border guidance, which includes these unlimited liability entities in its U.S. person definition. As the CFTC clarified in the CFTC Guidance, it is not necessary that the U.S. person majority owners have unlimited responsibility for **all** of the obligations of the entity.[12] Rather, the relationship to and risks flowing from the U.S. person's unlimited responsibility for some potential obligations and liabilities are sufficient to warrant U.S. person status for the entity itself. Additionally, the CFTC appropriately noted that it need not be **all** of the U.S. persons who are majority owners to bear unlimited responsibility; any U.S. person that bears unlimited responsibility is sufficient to convey U.S. person status.[13] Precisely the same logic applies under the SEC's statutory jurisdiction.

C. Collective investment vehicles that are majority-owned by U.S. persons are U.S. persons regardless of whether they are organized or incorporated in the United States.

As with unlimited liability entities, the SEC must include any collective investment vehicle ("CIV") that is majority-owned by one or more U.S. persons. Although, under the Proposal, CIVs that are organized or incorporated under the laws of the U.S. or that have their principal place of business in the U.S. would be considered "U.S. persons," the SEC must broaden this coverage and look through to the investors of the CIV.

As the CFTC has noted, CIVs "are generally passive investment vehicles that serve as a means to achieve the investment objectives of their beneficial owners, rather than being separate, active operating businesses. As such, the beneficial owners would be directly exposed to the risks created by the swaps that their collective investment

12 78 Fed. Reg. 45,312.
13 *Id.*

vehicles enter into."[14] The same is true within the realm of SBS transactions. Thus, the SEC should include CIVs that are majority-owned by U.S. persons.

D. Guaranteed affiliates and effectively guaranteed affiliates of U.S. persons must also be treated as U.S. persons.

Although not legally the same entity as their U.S. person guarantors, guaranteed affiliates must also be treated as U.S. persons by virtue of their relationship with the U.S. guarantor. As is the case with foreign branches of U.S. persons, guaranteed affiliates[15] pose a significant risk to the U.S. financial system, since the risk of non-performance on their SBS dealings traces back to the U.S. "to the same degree as if the transaction were entered into directly by a U.S. person."[16] In addition, guaranteed affiliates' counterparties rely on the creditworthiness of the guarantor, effectively considering themselves to be dealing with the guarantor. Without the guarantee of the parent, the client-facing affiliate would be considered entirely unsuitable.[17]

Thus, from a risk-based and practical perspective, guaranteed affiliates are indistinguishable from foreign branches. Indeed, some firms choose to operate through the former, others through the latter.[18] To adequately address the fact that, despite their "distinct legal status,"[19] guaranteed affiliates are effectively indistinguishable from their U.S. guarantor, the SEC must, as with foreign branches, include them within the definition of U.S. person for purposes of the cross-border application of Title VII.

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[14] CFTC Guidance, 78 Fed. Reg. 45,314.

[15] As appropriately noted by the CFTC, the term "guarantee" "include[s] the different financial arrangements and structures that transfer risk directly back to the United States," regardless of form. CFTC Guidance 78 Fed. Reg. 45,320. Thus, "guarantee" encompasses traditional guarantees, as well as, "keepwells and liquidity puts, certain types of indemnity agreements, master trust agreements, liability or loss transfer or sharing agreements, and any other explicit financial support arrangements." *Id.* at 45,320 n. 267.

[16] 78 Fed. Reg. 30,986.

[17] The CFTC appropriately recognized this in its cross-border guidance, stating "when a swap counterparty uses a guarantee as credit support for its swaps obligations, the guarantor's resources are added to the analysis of the swap because the market will not trade with that counterparty at the same price, on the same terms, or at all without the guarantee." CFTC Guidance, 78 Fed. Reg. 45,356 (internal quotations omitted).

[18] For instance, Goldman Sachs is well known to make use of wholly-owned subsidiaries. "Goldman Sachs Execution & Clearing, L.P. (GSEC), a limited partnership, registered as a U.S. broker dealer and futures commission merchant, together with its consolidated subsidiaries (collectively, the Company), is a wholly owned subsidiary of SLK LLC, a limited liability company. SLK LLC is a wholly owned subsidiary of Goldman Sachs Trade Management LLC, which is a wholly owned subsidiary of The Goldman Sachs Group, Inc. (Group Inc.), a Delaware Corporation." *See* 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.

[19] 78 Fed. Reg. 30,997.

Indeed, the Release appropriately recognizes the risk to the United States arising from offshore SBS where the transaction is guaranteed by a U.S. person, stating that such a transaction "poses the same risk to the United States as the risk posed by a transaction entered into directly by such U.S. person."[20] The Release also acknowledges that guaranteed affiliates' relationship to the U.S. is sufficient to consider transactions with those affiliates subject to Title VII, consistent with the territorial approach.[21] Yet, the Proposal nevertheless inappropriately fails to include guaranteed subsidiaries in the definition of U.S. person. This will elevate form over substance, encourage evasion, and defeat the purposes of the Dodd-Frank Act, and it must be corrected.

The SEC must also ensure that the term guaranteed affiliate is appropriately defined to include those affiliates that are ***de facto* guaranteed**, even though not explicitly subject to a guarantee agreement. **Both pose a significant risk of contagion to the U.S. guarantor in times of market stress.** Because of this connection to the U.S. "guarantor," the *de facto* guaranteed entity should be classified as a "U.S. person" under the SEC's territorial or anti-evasion authority.

Even when an affiliate lacks an explicit guarantee, it frequently possesses an implicit guarantee, if not on a transaction-by-transaction basis at least on a portfolio level. This is because reputationally, a dealer or large trader in the swaps market simply cannot afford to allow a supposedly non-guaranteed affiliate to fail, except in very marginal cases.

The "choice" to let an affiliate or subsidiary fail will inevitably be interpreted as a sign of balance sheet weakness or as a breach of a claimed prior understanding, practice, or expectation. As a result, any large market participant making such a decision will inevitably see a decline in business and order flow, likely precipitously and in very large amounts. In the most extreme case, a failure to bail out an entity that is *de facto* guaranteed can trigger a crisis of market and counterparty confidence, causing a sudden liquidity squeeze, precisely the conditions that caused the near collapse of the financial system post-Lehman bankruptcy.

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

Citigroup's structured investment vehicles ("SIVs") were just one high profile example of non-guaranteed subsidiaries that were eventually bailed out by the parent.[22] Citigroup engaged in extensive proprietary trading in the run-up to the crisis, much of which took place through either guaranteed conduits or non-guaranteed SIVs. In 2007,

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[20] 78 Fed. Reg. 30,977.

[21] 78 Fed. Reg. 30,987.

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

to avoid failure of its guaranteed conduits, Citigroup bought $25 billion of commercial paper that had been issued by its Super Senior conduits and placed those Super Senior securities on the books of the Citigroup commercial bank.[23] Citigroup also "chose" to bring $49 billion of SIV assets onto its balance sheet, **even though it had no legal obligation to do so**, since no guarantee was in place.[24] No distinction was made between the guaranteed subsidiaries and the non-guaranteed subsidiaries: Citigroup knew that to allow either to fail would have threatened the very existence of the bank.

Beginning in November 2007, Citigroup was forced to recognize huge losses on the Super Senior securities and other positions.[25] By the end of 2008 Citigroup had written off $38.8 billion related to these positions and to asset-backed securities and collateralized debt obligations it held in anticipation of constructing additional collateralized debt obligations.[26]

These losses dramatically reduced Citigroup's capital, helped to bring the company to the brink of failure, and required hundreds of billions of dollars in government bailouts. The amount of federal help required to prevent Citigroup from failing was breathtaking, including capital injections, debt guarantees, and asset guarantees.[27] Ultimately, Citigroup received more total aid than any other single entity or firm in connection with the financial crisis: $ 476 billion.[28]

Other transnational banks—including Barclays, HSBC, Dresdner, and Bank of Montreal—also moved de facto guaranteed SIV assets onto their balance sheets to avoid reputational damage.[29]

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

24 Citigroup Inc. 2007 10-K, at 163; *see also* Dan Gallagher & Simon Kennedy, *Citigroup says it will absorb SIV assets*, WALL ST. J., Dec. 14, 2007, *available at* www.marketwatch.com/story/citigroup-to-take-49-bln-of-siv-assets-onto-balance-sheet.

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

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

27 *See* Special Inspector General for the Troubled Asset Relief Program, *Extraordinary Financial Assistance Provided to Citigroup, Inc.*, Jan. 13, 2011.

28 The Treasury, Federal Reserve, and FDIC guaranteed $301 billion of Citigroup assets, and the bank was a large user of Federal Reserve emergency lending facilities. The Congressional Oversight Panel put total federal government exposure to Citigroup at $476.2 billion. *See*, Congressional Oversight Panel, March Oversight Report, Figure 7 (2011), *available at* http://cybercemetery.unt.edu/archive/cop/20110401232213/http:/cop.senate.gov/documents/cop-031611-report.pdf

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

Thus, regardless of whether an affiliate is "guaranteed" by a U.S. person, that affiliate may be effectively guaranteed, having the same connection with and posing the same risks to the United States. Indeed, both types of affiliates have a proven track record of causing potentially catastrophic losses to the U.S. actual or de facto guarantor. Both must be bailed out to avoid a loss of market and counterparty confidence, and both are therefore capable of generating huge, systemically significant losses for the actual or de facto guarantor.

This is so even if the affiliates in question are individually small, since as a group they can add up to significant losses. Among all the ABCP conduits rated by Moody's as of January 1, 2007, the mean asset size was only $4.1 billion. However, collectively these entities accounted for $1.2 trillion, an amount that was more than sufficient to cause serious damage to the balance sheets of the largest banks when significant losses occurred within those SIVs and conduits.[30]

This raises the question of where to draw the line in determining which affiliates are de facto guaranteed by a U.S. person and therefore subject to classification as a U.S. person for the purpose of cross-border application of SBS regulation. Whereas conduit affiliates[31] are a clear example of de facto guaranteed affiliates, others are not as apparent until it is too late and the de facto guaranteed entity is bailed out by the de facto guarantor. Several principles suggest themselves as an appropriate gauge:

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

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

- Third, the SEC should consider requiring a public filing by the de facto guarantor with the SEC committing that it will not provide such resources to the subsidiary under any circumstances, thereby triggering libaility under the Exchange Act if the de facto guarantor does in fact intercede in any way.

In addition to the principles suggested here, the SEC should consider other supplemental approaches. For example, the recent Vickers Report from the UK explored the concept of a "ring-fence" system to insulate depository institutions from trading

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

31 As defined by the CFTC, a conduit affiliate "encompasses those entities that function as a conduit or vehicle for U.S. persons conducting swaps transactions with third-party counterparties." 78 Fed. Reg. 45,358-59 (identifying appropriate factors to consider in determining whether a non-U.S. person is a conduit affiliate).

operations. In the UK's approach, retail banking must be clearly separated from investment banking, though common ownership is permitted. Within a banking corporation, retail operations must be established as separate legal entities from investment banking operations. All assets must be earmarked for one group or the other, with no possibility of asset transfer between subsidiary and parent. Assets that are on the balance sheet of the subsidiary cannot be taken onto the books of the parent, and vice versa.[32]

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

If a subsidiary or affiliate is ring-fenced, the SEC should require that the CEO or equivalent officer of the parent company notify the SEC and shareholders in writing whenever resources of the parent are used, directly or indirectly, to cover any obligation of a ring-fenced subsidiary. Failure to notify the SEC should be treated as misrepresentation by omission, at a minimum, and be enforced both by the SEC and an express private right of action.[33]

IV. The SBS Dealer *de minimis* calculation is under-inclusive, excluding many SBS transactions that should be counted when determining dealer status.

The aggregation of SBS for the purpose of determining who counts as a SBS Dealer is central to the entire cross-border SBS regulatory framework. This issue has taken on heightened importance due to weaknesses in the entity definitions already adopted. Under those rules, there is an excessively high major security-based swap participant threshold, which excludes almost all market participants.[34] Therefore, if large overseas entities heavily engaged in the SBS markets are to be subjected to proper oversight, it will likely be only under the mantle of SBS Dealer.

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32 Of course, this is an idealized version of the Vickers proposal, but the point is meant to be merely illustrative.

33 The profoundly important role of guarantees in the regulatory framework arises in a number of areas. For example, under the Proposal, foreign clearing agencies must register with the Commission as such if they have U.S. members, given potential risks to the U.S. However, under the basic rationale discussed in text above, the Proposal should also require foreign clearing agencies to register if they have non-U.S. person members that are guaranteed by U.S. persons.

34 *See* Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 77 Fed. Reg. 30,596 (May 23, 2012) (to be codified at 17 C.F.R. pt. 1, 240) ("Further Definitions Release").

The issue is further complicated by the extremely high *de minimis* threshold established by the SBS Dealer definitions rule. A $3 billion threshold is—as Better Markets has argued[35]—far too high, allowing many firms that engage in significant SBS trading to escape dealer registration and regulation. Using DTCC data, the SEC Division of Risk, Strategy, and Financial Innovation determined that 88 percent of the credit default swap ("CDS") market participants engage in less than $3 billion of CDS activity over a twelve month period.[36] At first blush, this might seem to support the idea that the threshold is well-placed. However, crucially it is only CDS activity **in which the party acts as a dealer** that is counted toward the determination of whether or not an entity is classed as an SBS-dealer. Therefore, considerably less than 12 percent of participants would be captured under a $3 billion threshold. Importantly, the SEC analysis also looked specifically at entities displaying SBS-dealer-like behaviors. They found that **over a third** of entities meeting **all three criteria** for SBS-dealer-like behaviors would not be captured under a $3 billion *de minimis* threshold.[37]

Under the Proposal, a non-U.S. person calculating its SBS dealing activity for purposes of the determining whether it exceeds the *de minimis* threshold and therefore must register as a SBS Dealer would count the notional amount of: its SBS dealing activity with U.S. persons (**other than foreign branches of U.S. banks**); and its SBS dealing activity within the United States. It would also have to aggregate and count the notional amount of: all of the SBS dealing activity of its U.S. affiliates, regardless of the counterparty or location of the transaction; all of the SBS dealing activity of its non-U.S. affiliates with U.S. persons (other than foreign branches of U.S. banks); and all of the SBS dealing activity of its non-U.S. affiliates within the United States.

The non-U.S. person would be permitted to exclude from the calculation, transactions of registered SBS Dealers that are operationally independent and cross-border SBS transactions between majority-owned affiliates.

This proposed approach to the SBS *de minimis* calculation appropriately includes transactions that are conducted within the United States.[38] As the Release notes, this would take into account the SBS Dealers organization models by "captur[ing] dealing activity undertaken by non-U.S. persons that are physically located within the United States, such as through a U.S. branch of a foreign bank, or through an agent, such as non-

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35 *See* Better Markets Comment Letter to the SEC Re: Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant;" File No. S7-39-10, Apr. 6. 2012, *available at* http://www.sec.gov/comments/s7-39-10/s73910-156.pdf.

36 SEC, Division of Risk, Strategy, and Financial Innovation, *Memorandum Re: Information regarding activities and positions of participants in the single-name credit default swap market*, at 6, Mar. 13, 2012, *available at* http://www.sec.gov/comments/s7-39-10/s73910-154.pdf.

37 *Id.* at 20.

38 The Proposal defines "transaction conducted within the United States" as any "'security-based swap transaction that is solicited, negotiated, executed, or booked within the United States, by or on behalf of either counterparty to the transaction, regardless of the location, domicile, or residence status of either counterparty to the transaction.' It would not, however, include a transaction conducted through a foreign branch of a U.S. bank. . . ." 78 Fed. Reg. 30,999-31,000; Proposed Rule 3a71-3(a)(5).

U.S. person's U.S. subsidiary or an unaffiliated third party acting on the non-U.S. person's behalf."[39]

Additionally, the Proposal appropriately only excludes swaps by affiliates that are registered SBS Dealers if they are "operationally independent."[40] This safeguard addresses concerns of evasion while promoting the statutory purpose of the *de minimis* exception.

However, two of the exclusions from the *de minimis* calculation are indefensible and must be eliminated: the exclusions for (1) guaranteed transactions and (2) transactions with foreign branches of U.S. banks.

A. Transactions with non-U.S. persons that receive guarantees from U.S. persons must be included in the *de minimis* calculation.

The Release appropriately notes that, with respect to transactions with non-U.S. persons with U.S. guarantees that take place outside the U.S., "the risk created for U.S. persons and the U.S financial system . . . is the same as the risk posed if the U.S. person who provides the guarantee had entered into transactions directly with non-U.S. persons."[41] However, once again, the Proposal ignores this rationale: It would **exclude** from a non-U.S. person's *de minimis* calculation transactions outside the U.S. by it or its non-U.S. affiliates, with non-U.S. persons, when either party is guaranteed by a U.S. counterparty.

The SEC's rationale for these exclusions is that the risks to the U.S. "arise only from the resulting positions and not the dealing activity," and therefore "can be best addressed through the major security-based swap participant definition and requirements applicable to major security-based swap participants."[42]

This, however, is as inadequate as it is inappropriate. Not only is it inconsistent with the acknowledged and stated risk-flow to the U.S., it would rely inappropriately on the Major Security-Based Swap Participant definition, with its high threshold and multiple safe harbors. The SEC itself has previously estimated it may cover "fewer than five" and in actuality "zero" market participants.[43] There is no reason to believe that foreign firms will be more likely to fall under the excessively high threshold outside the safe harbors than domestic firms.[44] Indeed, the Release states "[b]ecause non-U.S.

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[39] 78 Fed. Reg. 30,989 n. 198.

[40] According to the Release, "the security-based swap activities of two affiliates would be considered operationally independent if the two affiliated persons maintained separate sales and trading functions, operations (including separate back offices), and risk management with respect to any security-based swap dealing activity conducted by either affiliate that is required to be counted against their respective *de minimis* thresholds." 78 Fed. Reg. 31,005.

[41] 78 Fed. Reg. 31,006.

[42] 78 Fed. Reg. 31,006.

[43] Further Definitions Release, 77 Fed. Reg. 30,727.

[44] Not exempting transactions involving a U.S. guarantee outside the U.S. would also be consistent with the CFTC Guidance which would require a non-U.S. person to include its swap dealings with non-U.S.

persons must count only transactions with U.S. counterparties toward the substantial position and substantial counterparty exposure thresholds, the final number of registered major participants may be lower than the preliminary upper bound of five [previously estimated]. . . ."[45]

In short, this proposed exemption has the potential to create a large loophole for foreign market participants, while leaving the risk with the American taxpayer. Ignoring such an acknowledged risk would be arbitrary and capricious.

B. Transactions with foreign branches of U.S. banks should also not be excluded from the SBS Dealer *de minimis* calculation.

The Proposal would exempt from a non-U.S. person's *de minimis* calculation transactions outside the United States when the counterparty is a foreign branch of a U.S. bank. The Release states that without this exclusion, U.S. banks' access to non-U.S. counterparties could be limited when conducting their foreign SBS dealing activity through foreign branches. Supposedly, non-U.S. persons may not be willing to enter into transactions with foreign branches of U.S. banks, fearing they may trigger the SBS Dealer registration requirement. The SEC attempts to mitigate the consequences of this loophole by narrowly defining "foreign branch."[46]

However, this attempted narrowing is not enough. As the Proposal states, a branch is "merely an extension of the head office," and therefore must be considered a U.S. person for purposes of the cross-border application of Title VII.[47] Accordingly, the branch should be treated no differently than the U.S. person and thus included in the *de minimis* calculation.

Arguments against this approach are fundamentally flawed. As noted above, the Release speculates that foreign firms will fear the prospect of being "forced" to register as SBS Dealers if they enter into SBS with U.S. persons, thus potentially reducing some business opportunities of foreign branches of U.S. banks. This argument overlooks two key points.

First, given the $3 billion *de minimis* threshold, non-U.S. persons will be free to conduct a very substantial amount of SBS business with foreign branches of U.S. banks without any fear of a potential dealer registration requirement. It would be irrational for a firm to avoid all SBS transactions with U.S. persons given that they are permitted such a large amount of potentially lucrative SBS dealing activity without triggering a registration requirement. As the Release itself notes, the initial upper bound estimate of

guaranteed affiliates and would also require a non-U.S. affiliate of a U.S. person that is guaranteed by a U.S. person, or affiliate conduit of a U.S. person count all of its swap dealing activity, whether with a U.S. or Non-U.S. counterparty.

45 78 Fed. Reg. 31,138.

46 78 Fed. Reg. 31,002.

47 78 Fed. Reg. 30,997.

50 entities that would be required to register as SBS dealers "may be somewhat smaller" because of the *de minimis* calculation exclusions for foreign SBS dealers.[48]

Second, and even more important, the SBS Dealer registration requirement is only triggered by SBS **dealing** activities. Commercial hedging activities and even certain speculative trading activities are both explicitly excluded from the transactions that must be counted towards the $3 billion threshold.

This exception is no more than a loophole based upon a scare tactic, which will cause U.S. firms to operate their SBS business through offshore branches. The argument that no overseas firm will enter derivatives trades with U.S. banks through foreign branches is simply the latest attempt by self-interested financial industry participants to frighten the SEC into weakening the cross-border application of Title VII.

V. Distinguishing between entity-level and transaction-level requirements is appropriate, but the treatment and applicability of certain requirements must be changed.

A. The SEC's general distinction between entity-level and transaction-level requirements is valid.

The Proposal differentiates Title VII requirements based on whether they would apply to the entity or to the particular transaction. According to the SEC, the "[e]ntity-level requirements in Title VII primarily address concerns relating to the SBS dealer as a whole, with a particular focus on safety and soundness of the entity to reduce systemic risk in the U.S. financial system."[49] Therefore, the Proposal would treat the following as entity-level requirements: Capital, Margin, Risk Management, Recordkeeping and Reporting, Internal System and Controls, Diligent Supervision, Conflicts of Interest, Chief Compliance Officer, Inspection and Examination, Licensing Requirements, and Statutory Disqualification. In contrast, the SEC states that the focus of the transaction-level requirements is to protect the counterparty to the transaction, and therefore these would encompass External Business Conduct Standards, segregation requirements, regulatory reporting, public reporting, clearing, and trade execution.[50]

Characterizing a requirement as either entity-level or transaction-level will affect its applicability. If the requirement applies at the entity-level, the entity will have to comply with it regardless of the status of the counterparty or the location of the transaction. If the requirement applies at the transaction-level, the entity will generally have to comply with it in any transaction with a U.S. person **or** within the U.S.

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[48] 78 Fed. Reg. 31,137.
[49] 78 Fed. Reg. 31,011.
[50] 78 Fed. Reg. 31,010.

Each of these applications is generally appropriate. In particular, the SEC correctly took a territorial approach to the application of transaction-level requirements so that it would encompass any transaction with a U.S. person **or** within the U.S. As the SEC recognized, that approach will promote transparency, protect counterparties, and "achieve the financial stability goals of Title VII."[51]

However, distinguishing a particular requirement as either transaction-level or entity-level has profound implications for the application of substituted compliance under the Proposal, as discussed below.

B. The SEC should treat margin as a transaction-level requirement to minimize the application of substituted compliance to that critical regulatory safeguard.

The Proposal would allow substituted compliance for all foreign SBS Dealer entity-level requirements.[52] However, with respect to transaction-level requirements, the Proposal generally would not permit substituted compliance for foreign SBS Dealers in transactions with U.S. persons or transactions within the U.S. Therefore, in terms of avoiding Title VII regulation, there is an incentive for foreign SBS Dealers to prefer that a particular requirement be treated as an entity-level requirement, where it would be able to comply with only a comparable foreign regime in every circumstance, regardless of who they transact with or where the transactions occur.

Industry's motive for advocating for one approach over the other must be kept in mind when adopting final cross-border rules, particularly with respect to margin requirements. Under the Proposal, margin is treated as an entity-level requirement. As the SEC notes:

> Margin may be viewed as an entity-level requirement given its effect on the financial soundness of an entity, as well as a transaction-level requirement due to the fact that margin is calculated based on particular transactions and positions. Although margin is calculated based on individual transactions, the cumulative effect of collecting margin from counterparties is to protect an entity from the default of its counterparties. Given the emphasis placed on the financial soundness of security-based swap dealers in Title VII, we believe that margin should be treated as an entity-level requirement for purposes of implementing Title VII in the cross-border context.[53]

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51 78 Fed. Reg. 30,984.
52 78 Fed. Reg. 31,090.
53 78 Fed. Reg. 31,011.

It is undoubtedly true that margin, when considered in the aggregate, affects the entity as a whole and that margin should be collected in all transactions, not simply those facing U.S. persons. However, treating margin as an entity-level requirement presents a serious drawback, as it makes margin always subject to possible substituted compliance. Alternatively, treating margin as a transaction-level requirement would ensure compliance with U.S. margin requirements in transactions within the U.S. or with U.S. persons.

This alternate approach would appropriately apply U.S. law to transactions where the U.S. regulatory interest is strongest. Additionally, this approach is more consistent with the CFTC's cross-border guidance, which would apply U.S. margin requirements to foreign Swap Dealers in all transactions with U.S. persons.

In sum, the Commission should be mindful of the industry's underlying interest in classifying particular Title VII requirements as either transaction-level or entity-level under the Proposal. Additionally, because of the importance of margin and the need to apply the U.S. margin requirements outright in transactions with U.S. persons or within the U.S., where the U.S. has a particularly strong regulatory interest, the SEC should either treat margin as a transaction-level requirement or not permit substituted compliance in those transactions.

C. The exceptions for the mandatory SBS clearing and trade execution requirements are unacceptable.

Under the Proposal, the requirement for **mandatory SBS clearing** would apply to a person that engages in a SBS transaction if a counterparty to the transaction is (i) a U.S. person or (ii) a non-U.S. person whose performance under the SBS is guaranteed by a U.S. person. Additionally, it would apply if the SBS transaction is a transaction "conducted within the U.S." The Proposal permits two exceptions:

1) where the SBS transaction is not a "transaction conducted within the U.S.," and one counterparty to the transaction is (i) a foreign branch of a U.S. bank or (ii) a non-U.S. person whose performance under the SBS is guaranteed by a U.S. person, and if the other counterparty to the transaction is a non-U.S. person (i) whose performance under the SBS is not guaranteed by a U.S. person and (ii) who is not a foreign SBS Dealer; or

2) where the SBS transaction is a "transaction conducted within the U.S.," and (i) neither counterparty to the transaction is a U.S. person; (ii) neither counterparty's performance under the SBS is guaranteed by a U.S. person; and (iii) neither counterparty to the transaction is a foreign SBS Dealer.

The mandatory SBS **trade execution requirement** would, in turn, apply to all transactions subject to the mandatory clearing requirement.[54]

Although the general test for mandatory clearing, and by extension mandatory trade execution, is adequate, the exceptions must be eliminated. Specifically, the first exception would inappropriately apply in instances where there is a foreign branch of a U.S. bank or a guaranteed non-U.S. person. The Release attempts to justify this exception on the basis of preventing a speculative U.S. competitive disadvantage in foreign SBS markets. It states that "[w]ithout such an exception, U.S. persons conducting security-based swap activity out of foreign branches or guaranteed non-U.S. persons may have less access to foreign security-based swap markets because non-U.S. person counterparties may be less willing to enter into security-based swap transactions with them if such transactions are subject to a mandatory clearing requirement." At the same time, however, the Release recognizes that the inclusion of transactions with foreign branches would be consistent with the U.S. person definition and "that a U.S. guarantor is an indirect counterparty to the transaction entered into by the guaranteed non-U.S. person."[55] It also states that "such transactions pose risk to the U.S. financial system."[56]

Thus, despite recognizing these critical issues that mandate the application of clearing and trade execution requirements to all transactions with foreign branches or guaranteed non-U.S. persons, the SEC arbitrarily and capriciously subordinates them. Indeed, the exception would protect the hypothetical competitive commercial interests of U.S. SBS Dealers to the detriment of the U.S. economy and the U.S. taxpayer. Subordinating the goals of Title VII to competitive concerns—contrary to the language and purposes of the law—is plainly wrong.

The second exception is also flawed and inconsistent with the SEC's general cross-border approach. It fundamentally conflicts with the cornerstone of the SEC's jurisdiction: territoriality. As stated in the Release: "The Dodd-Frank Act was enacted, in part, to address the risks to the financial stability of the United States posed by entities bearing such risks, and a territorial approach to the application of Title VII should be consistent with achieving these statutory purposes."[57] And yet, the second prong above would exempt a variety of SBS transactions from the clearing and trade execution requirements, even when they are conducted within the U.S. This is indefensible and must also be eliminated.

54 78 Fed. Reg. 31,079.
55 *Id.*
56 *Id.*
57 78 Fed. Reg. 30,984.

D. The public dissemination requirement under Regulation SBSR must be expanded.

Under the Proposal, a SBS transaction is subject to public dissemination under Regulation SBSR if:

- The SBS is a transaction "conducted within the U.S.;"
- There is a direct or indirect (as by a U.S. person guarantee) counterparty that is a U.S. person on **each** side of the transaction;
- At least one direct counterparty is a U.S. person (except in the case of a transaction conducted through a foreign branch);
- One side includes a U.S. person and the other side includes a non-U.S. SBS Dealer; or
- The SBS is cleared through a clearing agency having its principal place of business in the United States.

Omitted from the public dissemination requirement would be SBS transactions that occur outside the United States that are between: (i) a foreign branch of a U.S. bank, a non-U.S. person SBS Dealer, or a non-U.S. person that has a guarantee from a U.S. person, and (ii) a non-U.S. person that is not guaranteed by a U.S. person.

However, consistent with the risks to the U.S. of certain entities identified in the Release and the importance of transparency and price discovery, the SEC must require public dissemination in all instances where there is a least one indirect counterparty (i.e. one counterparty that receives a U.S. guarantee) **or** where there is at least one foreign branch of a U.S. bank. The Release appropriately recognizes that:

> [I]f the reporting requirements do not apply to transactions among non-U.S. persons that receive guarantees from U.S. persons and foreign branches of U.S. banks, then U.S. persons would have an incentive to evade the reporting requirements by conducting transactions with other U.S. persons through guaranteed foreign affiliates or foreign branches. Altering the form of the transaction in this manner would allow U.S. persons to continue to avail themselves of transparency in the U.S. security-based swap market while themselves evading the requirements intended to enhance that transparency, even though the substance of the transaction remains unchanged.[58]

[58] 78 Fed. Reg. 31,062 n. 897.

This concern is no less important when only one party is a non-U.S. person that is guaranteed by a U.S. person, and it would apply equally in transactions involving one foreign branch of a U.S. bank.

In addition, public dissemination in transactions outside the U.S. that are between two foreign SBS Dealers must be required. The Release inappropriately excludes these transactions, stating that they are "less likely than a transaction conducted within the United States or a transaction involving a U.S. person on the other side to affect the U.S. security-based swap market."[59] However "less likely" they are to affect the U.S. SBS market, these transactions still must not be exempt. By definition, the non-U.S. SBS Dealer that is required to register has sufficient contacts with, and poses a sufficient risk to, the United States to warrant transparency in their SBS activity. Public transparency of these transactions is crucial.

VI. <u>The Proposal does not provide an adequate legal or policy justification for allowing substituted compliance, and if permitted at all, it must be substantially narrowed and subjected to much stronger criteria.</u>

According to the Proposal, "the Commission is proposing a policy and procedural framework that would allow for the possibility of substituted compliance in recognition of the potential, in a market as global as the security-based swap market, for market participants who engage in cross-border security-based swap activity to be subject to conflicting or duplicative compliance obligations."[60] Accordingly, "[a] person relying on a substituted compliance determination still would be subject to the particular Exchange Act requirement that is the subject of the substituted compliance determination, but would be permitted to comply with such requirement in an alternative fashion. Failure of a person to comply with the applicable foreign regulatory requirements would mean that such person would be in violation of the requirements in the Exchange Act."[61]

The Proposal relies heavily on this approach to substituted compliance, but it suffers from numerous flaws: It does not have an adequate justification, it should be prohibited altogether in certain circumstances, and it should be allowed only if more rigorous conditions are satisfied through a more transparent process.

A. <u>The Proposal does not justify the substituted compliance approach.</u>

Nowhere does the SEC address its authority for adopting such a framework, nor does it explain how the possibility of "conflicting or duplicative compliance obligations" justify supplanting Congress's determination that, to protect the American taxpayer and economy, those subject to the Commission's jurisdiction must comply with the actual provisions of the Dodd-Frank financial reform law. The SEC's duty is to protect investors and the public consistent with congressional policy, not to minimize the costs, burdens, or inconvenience that regulation imposes on industry. This is particularly important

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[59] 78 Fed. Reg. 31,063-64.
[60] 78 Fed. Reg. 30,973-74.
[61] 78 Fed. Reg. 31,085.

when any claimed industry burden is not only self-serving, but without basis and entirely speculative.

Had Congress intended the SEC to permit compliance with foreign regulation to suffice for all Title VII regulation of entities under U.S. jurisdiction, directly or by way of anti-evasion regulations, it certainly could have done so. For example, Section 17A(k) of the Exchange Act, as added by Section 763(b) of the Dodd-Frank Act, provides the SEC with authority to:

> exempt, conditionally or unconditionally, a **clearing agency** from registration under this section for the clearing of security-based swaps if the Commission determines that the clearing agency is subject to comparable, comprehensive supervision and regulation by the Commodity Futures Trading Commission or the appropriate government authorities in the home country of the agency . . . .[62]

Yet, Congress did not broaden this authority to include other entities or activities, such as SBS Dealers.

Moreover, the SEC's statutory duty under Section 712(a)(2) of the Dodd-Frank Act to "consult and coordinate" with foreign regulators on the establishment of "consistent international standards" does not require or justify the "substituted compliance" approach. The Dodd-Frank Act in effect expresses a preference for consistent standards, but this is fundamentally different from the substituted compliance approach, which withdraws U.S. standards altogether in deference to foreign standards.

This very restrained approach to harmony and consistency by Congress makes sense because substituted compliance poses significant risks and creates enormous opportunities for regulatory arbitrage. Regulatory arbitrage, in turn, encourages a race to the regulatory bottom so that financial firms can increase profits by avoiding regulations that protect the American people and taxpayers.

Even regimes of comparable robustness will inevitably contain asymmetries that could potentially generate loopholes for risky operations. The financial industry is the among the most notorious business sectors for searching the globe to exploit such loopholes. For example, does JP Morgan Chase really need 2,993 subsidiaries or Goldman Sachs and Bank of America 2,000 each or Citigroup 2,328?[63]

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62 15 U.S.C. § 78q-1(k) (emphasis added); *see also, e.g.*, Section 763(c) of the Dodd-Frank Act which uses the same exemptive language for security-based swap execution facilities.

63 Data obtained from http://www.ffiec.gov/nicpubweb/nicweb/OrgHierarchySearchForm.aspx?parID_RSSD=1039502&parDT_END=99991231, May 23, 2013. *See also* Avraham, D., Selvaggi, P., & Vickery, J., *A Structural View*

Financial firms have again and again demonstrated that they are willing to go to the limits of the law (and beyond) in search of profit. Therefore, the SEC must change its approach to substituted compliance.

Rather than following a substituted compliance approach, the SEC should use its exemptive authority sparingly, and only upon a finding of **actual conflict** with a particular foreign regulation. Legally this is appropriate. While the Dodd-Frank Act includes only limited reference to deferring to foreign country regulation, the SEC has general exemptive authority, which governs any suspension or relaxation of U.S. law. Under that authority the SEC:

> may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title [15 USCS §§ 78a et seq.] or of any rule or regulation thereunder, **to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.**[64]

Consistent with this authority, the SEC should only allow foreign regulation to control on a case-by-case basis, when it would be impossible for an entity subject to dual regulatory regimes to comply with two particular regulations; when it would be in the public interest and consistent with the protection of investors; and when foreign law is sufficiently strong and comprehensive.

This approach would be much simpler and more straightforward than the approach proposed in the Release. It would also better safeguard the American people from financial disasters by applying U.S. regulation unless and until the SEC explicitly finds that it would be in the interest of the public and investors to permit an exemption. More importantly, it would be consistent with the law.

B. Substituted compliance should never be permitted in certain circumstances.

1. *Substituted compliance should not be allowed as to transactions with U.S. persons or transactions occurring within the United States.*

Notwithstanding a questionable legal basis, if the SEC were to permit substituted compliance, it is in no case appropriate for U.S. persons, even when the transaction is considered to occur outside the United States. The SBS activities of a U.S. person directly and immediately impact the United States and endanger the U.S. taxpayer if improperly regulated. Despite this strong U.S. regulatory interest, the Proposal would generally allow substituted compliance for transactions with U.S. persons that occur outside the

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of U.S. Bank Holding Companies, Federal Reserve Bank of New York (2012), *available at* http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf.

64 15 U.S.C. §78mm (emphasis added).

United States. Additionally, in transactions between non-registrants where at least one counterparty is a U.S. end-user, the SEC would generally always permit substituted compliance where the transaction-level requirements apply.

Even more troubling is the fact that foreign branches of U.S. SBS Dealers, which **are U.S. persons**, would be permitted to claim substituted compliance with U.S. transaction-level requirements in almost all cases, regardless of with whom or where the transaction takes place, except when dealing with foreign persons without a U.S. guarantee outside the U.S.—where generally Title VII would not apply at all.

All of these carve-outs essentially nullify U.S. law in favor of foreign regulatory requirements, and they are unacceptable. Substituted compliance is simply impermissible for transactions with U.S. persons or for transactions that occur within the United States, regardless of the status of the counterparty.

2. *Substituted compliance should not be permitted as to External Business Conduct Standards for transactions with U.S. persons.*

In any SBS transaction between a non-U.S. SBS Dealer and a U.S. person, regardless of location, External Business Conduct Standards should apply outright, with no allowance for substituted compliance. Additionally, **U.S.** SBS Dealers must always be required to comply with U.S. External Business Conduct Standards, regardless of counterparty or location, and without any allowance for substituted compliance.

External Business Conduct Standards provide important protections to counterparties of SBS Dealers by, among other things, requiring SBS Dealers to:

(i) verify that a counterparty meets the eligibility standards for an ECP;

(ii) disclose to the counterparty material information about the SBS, including material risks and characteristics of the SBS, and material incentives and conflicts of interest of the Dealer in connection with the SBS;

(iii) provide the counterparty with information concerning the daily mark for the SBS;

(iv) communicate information in a fair and balanced manner based on principles of fair dealing and good faith; and

(v) in the case of special entity advisers, act in the "best interests" of the special entity and undertake "reasonable efforts to obtain such information as is necessary to make a reasonable determination" that a recommended security-based swap is in the best interests of the special entity.[65]

However, the Proposal would only apply External Business Conduct Standards to (1) the U.S. business of foreign SBS Dealers and (2) transactions of U.S. SBS Dealers, **except** for those conducted through their foreign branches with non-U.S. persons or foreign branches of U.S. banks. Furthermore, substituted compliance would be available to foreign SBS Dealers in their U.S. business, which the Proposal defines as any transaction with a U.S. person or within the U.S.

First, this proposed application of External Business Conduct Standards to foreign SBS Dealers is wholly inappropriate, and it is inconsistent even with a strictly "territorial" approach to cross-border regulation. Under the Proposal, a foreign SBS Dealer transacting with a U.S. person **even in the territorial U.S.** would be permitted, through substituted compliance, to avoid direct U.S. regulation and comply with foreign regulation. That is simply not consistent with U.S. law and cannot be permitted.

The External Business Conduct Standards are designed to promote full disclosure and fair dealing, and they are especially important where a "special entity" is involved, since those counterparties are entitled to a "best interest" standard. Depriving U.S. persons of these protections in U.S. transactions, simply because a foreign dealer is involved, will inevitably lead to weaker protections for U.S. persons, and it will surely come as a surprise to U.S. persons who naturally expect that U.S. law will apply to U.S. transactions.[66]

Second, transactions of U.S. SBS Dealers must always be subject to External Business Conduct Standards, **including** those conducted through their foreign branches with non-U.S. persons and foreign branches of U.S. banks. Although the SEC purports to mitigate the concerns surrounding this proposed exemption by narrowly defining when a transaction is conducted though a foreign branch and narrowly defining "foreign branch" itself, this is insufficient. A foreign branch is not a separate entity from the U.S. head office and is thus part of that U.S. person. Moreover, it is reasonable for non-U.S. persons to expect U.S. requirements, particularly External Business Conduct Standards, to apply in transactions with entities that are U.S. persons.

[65] 78 Fed. Reg. 31,010. These standards also include provisions relating to fraud, manipulation, and other abusive practices involving SBS and position limits. However, these provisions are not yet subject to Commission rulemaking and as the Release appropriately notes, the SEC will consider their application to foreign SBS Dealers if and when they are subject to rulemaking. 78 Fed. Reg. 31,018.

[66] *Cf.* Rest. (Third) of Foreign Relations Law of the United States § 403(2)(d) (stating that one of the factors to consider in determining the reasonableness of exercising jurisdiction over a foreign person is "the existence of justified expectations that might be protected or hurt by the regulation.").

3. Substituted Compliance should not be available as to Major SBS Participants without reliable and comprehensive data showing that it is prudent to permit.

The Proposal appropriately declines to permit Major SBS Participants to avail themselves of substituted compliance at this time. As the Release explains, they may engage in a variety of business activities and "it is not clear what types of entity-level regulatory oversight, if any, especially with respect to capital and margin, a foreign major security-based swap participant would be subject to in the foreign regulatory system."[67] Therefore, the Proposal declines to extend a substituted compliance framework to Major SBS Participants "in light of the limited information currently available to [the SEC] regarding what types of foreign entities may become major security-base swap participants, if any, and the foreign regulation of such entities."[68]

Given the lack of data and limited information before the SEC, this is the appropriate approach. As stated above, substituted compliance should not be permitted at all. But if it is nonetheless allowed, the SEC should not consider it at all in this context until and unless industry participants provide reliable and comprehensive data proving that it would be otherwise prudent to do so. And even under those circumstances, the SEC should apply substituted compliance sparingly and in accordance with the recommendations discussed herein.

C. Even where permitted, substituted compliance should be subject to more rigorous tests and a more public process.

If the SEC implements a substituted compliance regime, it must narrow and strengthen the approach in numerous ways.

- It must abandon the regulatory objectives test, and ensure that any foreign regulation that is appropriate for substituted compliance is 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 SEC if either the relevant regulation or the factors that qualified the entity for substituted compliance change in any material way.

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[67] 78 Fed. Reg. 31,036

[68] *Id.*

- Any substituted compliance determination must be periodically reviewed and renewed.

- In all cases, the process for determining whether to grant substituted compliance must be a public process, subject to notice and comment.

1. The SEC must abandon the regulatory outcomes test.

At a minimum, the SEC must abandon its reliance on the overly vague "regulatory outcomes" test. Rather than focusing on whether the actual requirements of a foreign regime are comparable to U.S. requirements on a rule-by-rule basis, the SEC intends to adopt a broader approach that examines more generally whether the regulatory "outcomes" are comparable.[69] Even assuming one can ever predict whether regulatory outcomes will be comparable, this standard is far too broad and it will allow substituted compliance under wholly inadequate foreign regulation. Conversely, a rule-by-rule approach would allow for an appropriately detailed assessment.

Moreover, the Proposal appears to apply different substituted compliance "outcomes-based" determinations depending on the requirement. For example, with respect to regulatory reporting and public dissemination requirements, the Release states that the SEC will focus on whether particularized elements are comparable, such as the reported data and manner and timeframe for reporting. Not only is it confusing to create particularized determinations for some but not all requirements, it creates the opportunity for the Commission to approve much more relaxed foreign regulations based on more vague standards. The SEC must ensure that for each requirement, there is a consistently robust and publicly disclosed standard to guide the substituted compliance determinations. To do otherwise would be arbitrary and capricious.

2. The SEC must ensure that the foreign regulation is comparable in substance, form, and over time.

The Proposal states that in making a substituted compliance determination, the SEC intends to consider certain factors. Some of these factors have no place in the assessment of a foreign regulatory regime, including whether substituted compliance will promote market efficiency and a well-functioning global market. In addition, the Release includes only passing reference to foreign supervision and enforcement as discretionary factors the SEC may consider in making a substituted compliance determination. Coming from an agency charged with the protection of U.S. investors, the U.S. financial system, and U.S. taxpayers, much more is necessary.

If it is permitted at all, substituted compliance must only be allowed if the foreign regulations are comparable in form, substance, supervision, and enforcement over time.

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[69] 78 Fed. Reg. 31,085.

To make this determination, the SEC must evaluate a host of factors regarding the foreign regulatory system, including staff expertise, agency funding, agency independence, technological capacity, supervision **in fact**, and enforcement **in fact**. Moreover, although an MOU with any foreign authority would be required regarding supervision and enforcement, the Proposal specifies no elements that would have to be included in such an MOU regarding, for example, information sharing, access to books and records, service of process, and many other essential areas of collaboration.

In addition, actual enforcement must be the case not just at one moment in time, but on an ongoing basis. The SEC must determine that there is a track record of robust enforcement by the foreign jurisdiction before making or renewing any such finding.

The importance of this approach is revealed in the major failings in European financial market regulation. The costs of those failures have been staggering, exceeding the GDP of several countries. For example, in 2009, **just one** of the five dealer banks nationalized in the United Kingdom, the Royal Bank of Scotland, had total assets, and therefore total liabilities, of 2.2 trillion pounds. In sharp contrast, the entire GDP for all of the UK in 2008 was only 1.4 trillion pounds. And, that is only the liabilities of **one** of the five nationalized dealer banks.

Because these costs are ongoing, it is impossible to calculate how much in total they will exact from the people of Europe. But, the costs to European citizens as a result of the nationalization of the banks and dealers (See Figure 18), will certainly be in the trillions of dollars.[70]

It is indisputable that foreign regulations and foreign regulators have failed miserably to protect their own depositors, investors, taxpayers, and treasuries.

Foreign financial regulation has failed in areas outside the financial crisis as well. For example, there has been massive, wide-spread, multi-year LIBOR rate-rigging throughout the EU by the large dealer derivatives desks. Additionally, there has been massive, wide-spread, multi-year criminal money laundering by Standard Chartered, HSBC, and other global bank/dealers, which was also undetected by European regulators. And, many of these regulatory failures are ongoing, prompting the question: Why would the SEC outsource the protection of U.S. taxpayers to any regulators with such a poor record?

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70 *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.pdf, incorporated here as if fully set forth herein.; *see also* Tyler Atkinson et. al, Dallas Fed, How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis, Staff Papers No. 20 (Jul. 2013), *available at* http://dallasfed.org/assets/documents/research/staff/staff1301.pdf; 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), *available at* http://gao.gov/assets/660/651322.pdf.

In addition, it must be recognized that foreign governments have a conflict of interest in enforcing effective rules on foreign banks: less or ineffective regulation will attract business, jobs, revenue, and tax receipts to their countries, with limited downside because the U.S. will, as it has before, pay the bill to bailout the global financial system. (See Figure 12).

That is why the SEC was given the statutory duty to regulate these markets and market participants **either** when they are within the U.S. jurisdiction **or** whenever necessary to prevent evasion of U.S. regulation. The United States, as the ultimate backstop to the global financial system, has a greater incentive to prevent the need for another bailout and it must do so quickly through the adoption of robust cross-border provisions. If the SEC chooses to permit substituted compliance, it must carefully assess not only the language of a particular foreign regulation, but also whether the particular foreign regulator has a robust track record of enforcement and a commitment to continued enforcement.

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

The SEC should explicitly state how it will police and enforce these requirements. In the absence of clear guidance to this effect, foreign operations and jurisdictions will lack a sufficiently strong incentive to fully comply.

3. *The process for making a substituted compliance determination must be more transparent.*

The Proposal would allow the SEC to determine **"in its sole discretion"** whether to publish notice of an application for substituted compliance and to allow the public to submit comment or information regarding the application.[71] For an agency charged with ensuring disclosure in our markets, this lack of transparency regarding its own processes is unacceptable on issues of such importance.

Allowing substituted compliance effectively entails outsourcing the protection of U.S. investors, U.S. taxpayers, and the U.S. economy to a foreign governmental authority. On a matter of such consequence, the SEC must follow a fully transparent approach and allow all interested parties the opportunity to submit their views every time a substituted compliance application is filed.

[71] 78 Fed. Reg. 31,206 (Proposed § 240.0-13 (h)).

VII. Cross-border derivatives activity poses major risks to U.S. markets, and it must be aggressively regulated under Title VII without delay so that those risks can be detected, minimized, and contained.

A. The derivatives market is highly global and interconnected.

The sheer size and global scope of the SBS Dealer community make cross-border regulation critical. As the Release points out, the vast majority of transactions in single-name CDS are conducted by the ISDA-recognized dealers (83.7 percent).[72] As of 2013, those dealers consisted of a mix of the largest U.S. and international banks, including Barclays Capital, BNP Paribas, Bank of America-Merril Lynch, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan, Morgan Stanley, Nomura, Royal Bank of Scotland, Societe Generale, UBS, and Wells Fargo.[73] (See Figure 2).

JP Morgan Chase alone, the world's biggest bank, illustrates the vast international network that these institutions have established. JP Morgan has $2.3 trillion in assets under U.S. accounting standards and more than $3.75 trillion under international accounting standards; more than 250,000 employees worldwide; operations in more than 60 countries; thousands of legal entities worldwide; and the ability to establish foreign legal entities virtually instantly and anywhere, at very little cost. (See Figures 3, 4, & 5 and see Figures 6-11 for size and global reach of Bank of America and Goldman Sachs).

Moreover, as the Commission itself recognized, when properly accounting for the status of foreign branches and foreign subsidiaries of U.S. entities, about 82 percent of all transactions involve a U.S.-domiciled entity.[74]

These facts confirm that the SBS market, by its global nature, can only be regulated effectively if Title VII applies across international boundaries.

B. History has repeatedly illustrated the high levels of risk that derivatives markets can generate.

It is no secret that both the overseas operations of U.S. firms and the market activities of firms headquartered outside of the United States were central to the last financial crisis. AIG remains the prime example of the problems that can arise when a major U.S.-based corporation conducts significant operations overseas.

AIG FP was a subsidiary of AIG with huge over-the-counter derivatives activities in London, supposedly under the regulatory purview of the UK's Financial Services Authority. The losses on its CDS trades necessitated a $182 billion bailout of the U.S.

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72 78 Fed. Reg. 31,120-21 & n. 1306 (using ISDA-recognized dealers as of 2010, which include Lehman Brothers, but does not include Wells Fargo or Nomura, which as of 2013 are ISDA-recognized dealers).

73 ISDA, *2013 ISDA Operations Benchmarking Survey*, Apr. 2013, *available at* http://www2.isda.org/attachment/NTUzOQ==/OBS%202013%20FINAL%200425.pdf.

74 78 Fed. Reg. 31,123-24.

parent company by the U.S. government and taxpayers.[75] Thus, although AIG's CDS business was operated out of London, the bill for its collapse was handed to the American taxpayer.[76]

Less well known, but equally important, is the revelation that over half of the AIG bailout funds eventually made their way to foreign banks.[77] (See Figure 1). Additionally, a GAO report determined that trillions of dollars of near zero-rate loans were made by the Federal Reserve to foreign banks.[78] And, it has been widely publicized that the single biggest borrower from the Federal Reserve's discount window at the height of the crisis in late October 2008 was Dexia, a Belgian bank.[79] (See Figure 16 and Figures 13-17 for borrowing by other foreign firms). This evidence makes it abundantly clear that U.S. corporate operations overseas **and** foreign financial institutions pose an immediate and substantial threat to the stability of the U.S. financial system and economy.

And, this is true regardless of the legal relationship between cross-border entities. Citigroup and Bear Stearns also suffered major losses passed through from affiliates housed in the Cayman Islands.[80] The tens of billions of dollars of losses to Citigroup in 2008, which occurred as a result of it absorbing losses from its "bankruptcy remote" SIVs, illustrate the danger posed by entities that are merely sponsored by financial institutions without any formal or informal guarantee or obligation.[81]

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 Chase suffered enormous losses from derivatives trades executed through its London Chief Investment Office (a branch), causing over $6 billion in direct losses and over $20 billion in market capitalization losses.[82] 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

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

76 *See* GAO, OPPORTUNITIES EXIST TO STRENGTHEN POLICIES AND PROCESSES FOR MANAGING EMERGENCY ASSISTANCE, GAO-11-696, July 21, 2011, *available at* http://www.gao.gov/products/GAO-11-696.

77 Michael Mandel, *German and French banks got $36 billion from AIG Bailout*, BLOOMBERG, Mar. 15, 20009, *available at* http://www.businessweek.com/the_thread/economicsunbound/archives/2009/03/german_and_french.html.

78 *See* GAO, OPPORTUNITIES EXIST TO STRENGTHEN POLICIES AND PROCESSES FOR MANAGING EMERGENCY ASSISTANCE, GAO-11-696, July 21, 2011, *available at* http://www.gao.gov/products/GAO-11-696.

79 Bradley Keoun, *Dexia Drew Most From Discount Window in Record Week in 2008*, BLOOMBERG, Mar. 31, 2011, *available at* http://www.bloomberg.com/news/2011-03-31/belgium-s-dexia-drew-most-from-discount-window-during-record-week-in-2008.html.

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

81 *See* Better Markets Comment Letter, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies" (Dec. 19, 2012), at 8, note 21, *available at* http://www.regulations.gov/#!documentDetail;D=FSOC-2011-0001-0082.

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

in derivatives markets.[83] The trades were all conducted through a foreign branch in London, but the losses went straight to the Swiss parent company.[84]

These many episodes from before, during, and after the financial crisis confirm the urgent need for strong regulation of cross-border activity, no matter what corporate form or vehicle a financial firm may choose to use for its international SBS trading.

C. The SEC must finalize its Proposal quickly, and any delay or weakening of the rules in the hope of strong foreign regulation is unwarranted.

To properly protect the American people from another financial collapse and economic crisis, the SEC must quickly finalize the Proposal, incorporating the strongest possible measures. Any delay in extending the protections in Title VII to cross-border activity is pointless and in fact, dangerous. There is no reason to wait for any other regulatory regime, and the longer we wait for cross-border regulation, the greater the risk that derivatives markets will incubate unsafe and costly risks to the U.S. financial system.

We have been fortunate that no crisis-level events have occurred over the past three years while the financial regulators have labored over the rulemaking and implementation of the Dodd-Frank Act. However, the recent losses incurred by JP Morgan through its London operations illustrate that unless meaningful cross-border enforcement of the Dodd-Frank Act provisions is implemented quickly, we are inviting catastrophe into our system.

1. *Neither international harmony nor principles of comity can justify delay.*

There is certainly no legal justification for yielding to actual or prospective foreign regulatory standards as the SEC finalizes the Proposal. Section 752(a) of the Dodd-Frank Act regarding international harmonization and principles of international comity do not dictate otherwise. In fact, Section 752(a) can and should be read as an attempt to raise international regulatory standards so that they harmonize with U.S. standards, rather than an effort to lower U.S. standards in the interest of harmony.[85] Finalizing cross-border rules will actually encourage other foreign regulators to follow the U.S. in establishing robust Title VII-like derivatives regulation.

83 Jonathan Russell, *UBS rogue trader Kweku Adoboli jailed for seven years*," THE TELEGRAPH, Nov. 20, 2012, *available at* http://www.telegraph.co.uk/finance/financial-crime/9690206/UBS-rogue-trader-Kweku-Adoboli-jailed-for-seven-years.html.

84 Victoria Callaghan, *FSA fines UBS £29.7 million*, LEXOLOGY, Nov. 29, 2012, *available at* http://www.lexology.com/library/detail.aspx?g=4ceda0c8-e538-4fd4-9bf2-9decca445fd4.

85 Additionally, Section 752(a) simply requires the Commission to "consult and coordinate" with foreign regulatory authorities on the establishment of consistent international standards regarding SBS. It does not require any specific outcome, substantive rule provision, or other action by the Commission with respect to its SBS rules or its cross-border release, and it certainly does not justify any dilution or delay of the Proposal.

Moreover, while principles of international comity are relevant to the U.S.'s application of U.S. law beyond direct U.S. jurisdiction, their relevance must not be overemphasized or decontextualized. The Dodd-Frank Act is constructed in such a way that comity is already considered and written into the law: the application of U.S. law is limited to entities within the jurisdiction of the U.S. and to entities without the jurisdiction of the U.S. as the SEC finds is necessary or appropriate to regulate to prevent evasion of U.S. law. The SEC must therefore remain focused on its task of protecting the U.S. taxpayer by quickly finalizing robust cross-border rules that appropriately implement the Dodd-Frank provisions governing the SBS market.

2. *Foreign regulators are years away from implementing comprehensive derivatives regulation.*

On a pragmatic level, delay or dilution of the SEC's cross-border standards cannot be justified. First, the Europe Union is 2 to 5 years behind the U.S. in terms of establishing and implementing comprehensive Title VII-like derivatives regulation. The EU is currently working on finalizing and implementing the European Market Infrastructure Regulation ("EMIR")[86] and the revised Markets in Financial Instruments Directive and Regulation ("MiFID2/MiFIR")[87], which together amount to Title VII-like comprehensive derivatives regulation. EMIR, which governs clearing and data reporting, has been delayed and it will not become fully effective until early next year, assuming there are no further delays.[88] Similarly, MiFID2/MiFIR, which govern, among other things, execution, trading, and position limits will not be finalized for years.[89]

This delay is attributable, in part, to Europe's convoluted and multi-track process for laws and regulations. Level 1 has 3 steps: (1) the European Commission ("EC"); (2) the European Parliament ("EP") and European Council ("Council") (acting parallel, but independently); and (3) Trialogue negotiations, votes, etc. Level 2 involves guidance and national implementation. However, even once this process is "finalized," there are objection periods when the Council and EP may, and do, delay the process further.

The difficulties and timeliness of this process is made clear by the current status of EMIR and MiFID/MiFIR 2.

With respect to EMIR, the European Securities and Market Authority ("ESMA") finished its level 2 technical requirements (which is roughly the equivalent of a SEC rulemaking) in late 2012. It was then challenged by the EP, and was subsequently modified and has now been approved. As a result, clearing is supposed to begin next

86 *See generally* http://www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR.

87 *See generally* http://www.aima.org/en/regulation/markets-regulation/derivativesclearing/mifid-mifir.cfm.

88 *See ESMA proposes delay to reporting date for Exchange Traded Derivatives*, http://www.esma.europa.eu/node/67001.

89 *See Fears Grow as MiFID II Delays Continue*, MARKETS MEDIA, Mar. 28, 2013, https://marketsmedia.com/fears-grow-as-mifid-ii-delays-continue/; *Whither MiFID? The Future of EU Financial Services Regulation*, BLOOMBERG BNA, July 30, 2013, http://www.bna.com/whither-mifid-future-n17179875549/.

year and will be gradually phased in. However, no mandatory clearing determination by ESMA has yet been made. Data reporting has been delayed, and according to ESMA's most recent estimate in August 2013, reporting of over-the-counter derivatives will not occur until January 2014, while reporting of listed derivatives will not occur until January 2015, unless, of course, there is yet another delay.[90]

With respect to MiFID2/MiFIR, they were approved in June 2013 by the Council and EP and now move to Trialogue negotiations wherein the EP, EC, and Council are beginning to negotiate the provisions for the final document. ESMA is starting in parallel to work on some technical standards, but will need the final text resulting from the Trialogue negotiations to complete most of them, which will then have to be implemented. That could (and almost certainly will) take years. The EMIR Trialogue, which was less controversial than the MiFID2/MiFIR Trialogue will be, missed several deadlines and took longer than expected. It is therefore virtually certain that estimates of the timeline for finalizing MiFID2/MiFIR are too optimistic. Ultimately, MIFID2/MiFIR will not be in effect until at least 2015 and may not be until 2018. [91]

Therefore, it is imperative that the SEC act now to ensure the protection of the American taxpayer and economy, and that it do so regardless of any calls for delay or weakening of the U.S. cross-border regime to accommodate foreign regulators.

VIII. As it finalizes all of its rules, the SEC should adhere to a number of core principles governing the economic analysis actually required under the securities laws.

A critically important aspect of the SEC's rulemaking process is the way in which it approaches economic analysis. The Release reflects this fact, since economic analysis is one of the specific issues on which the SEC requested further comment. As stated in the Release, the SEC "specifically seeks comment on the . . . economic consequences and effects, including costs and benefits, of the Proposed Rules, either individually or as a whole."[92] This issue is also fundamentally important because the SEC's approach to economic analysis affects **all** of the proposed rules, regardless of their specific substantive focus.

In reality, and as discussed in detail below, the SEC's statutory duty is narrow: it need not conduct a cost-benefit analysis for any of its rules, and its first priority in the rulemaking process is to protect investors and serve the public interest, not compromise the strength of its regulations to accommodate industry's often baseless cost concerns or speculative and hypothetical competitive issues.

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[90] Tim Cave, *Esma confirms futures reporting delay*, FIN. NEWS, Aug. 9, 2013, *available at* http://www.efinancialnews.com/story/2013-08-09/esma-confirms-futures-reporting-delay?ea9c8a2de0ee111045601ab04d673622.

[91] *See also* Simon Johnson, *Europe's Slow Financial Reforms*, ECONOMIX NY TIMES, Aug. 15, 2013, *available at* http://economix.blogs.nytimes.com/2013/08/15/europes-slow-financial-reforms/?ref=business (noting additional delays in EU financial regulation)

[92] 78 Fed. Reg. 30,802.

Nevertheless, even when the SEC has clearly fulfilled its limited statutory duty to consider the economic impact of its rules, representatives from industry have challenged proposed rules claiming—without merit—that the SEC failed to appropriately conduct what the industry calls "cost-benefit analysis." These attacks rest on a series of fundamentally flawed claims. For example, in challenging rules promulgated by the Commission, the industry has:

(1) greatly exaggerated the actual duty imposed on the Commission by its governing statutes, Sections 3(f) and 23(a)(2) of the Exchange Act, in effect seeking to transform that limited duty into what they call "cost-benefit analysis," but which is in really an "industry cost-only analysis;"

(2) entirely disregarded the paramount statutorily required role of the public interest in the rulemaking process; and

(3) indefensibly ignored the enormous cost of the financial crisis and the larger collective benefit of all rules designed to help prevent a recurrence of that crisis or something far worse.[93]

Accordingly, as the Commission finalizes the Proposal, it is imperative that it adhere to a series of core principles governing the actual contours of its duty to consider the economic impact of its rules.

A. Under the securities laws, the Commission has no statutory duty to conduct cost-benefit analysis; its far more narrow obligation is simply to consider certain enumerated factors.

Sections 3(f) and 23(a)(2) of the Exchange Act set forth the Commission's statutory requirement to "consider" a rule's impact on several specifically listed economic factors.[94] Specifically, Section 3(f) requires the Commission, after considering "the public interest" and the "protection of investors," "to consider . . . whether the action will promote efficiency, competition, and capital formation." Section 23(a)(2) requires the Commission to "consider among other matters the impact any such rule or regulation would have on competition," and to refrain from adopting the rule if it "would impose a burden on competition not necessary or appropriate in furtherance of the

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[93] *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.pdf, incorporated here as if fully set forth herein.; *see also* TYLER ATKINSON ET. AL, DALLAS FED, HOW BAD WAS IT? THE COSTS AND CONSEQUENCES OF THE 2007-09 FINANCIAL CRISIS, STAFF PAPERS NO. 20 (Jul. 2013), *available at* http://dallasfed.org/assets/documents/research/staff/staff1301.pdf; 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), *available at* http://gao.gov/assets/660/651322.pdf.

[94] 15 U.S.C. §§ 78c(f), 78w(a)(2).

purposes of [the statute]."[95] The Exchange Act contains no language requiring a cost-benefit analysis and there is no basis for imposing any such requirement.

When Congress intends cost-benefit analysis to apply, it explicitly refers to "costs" and "benefits" and specifies the nature of the analysis.[96] And, when Congress wants agencies to be free from those constraints, it imposes a less burdensome requirement, thus giving overriding importance to particular statutory objectives.[97]

Recently, the Court of Appeals for the District of Columbia confirmed these principles.[98] The Court addressed the CFTC's economic analysis duty under Section 15(a) of the Commodity Exchange Act ("CEA"), which is similarly framed in terms of a duty to "consider" certain factors. Even though the CEA actually references "costs" and "benefits," the Court made clear that the duty simply to "consider" such factors is a limited one and does not require a cost-benefit analysis:

> The appellants further complain that CFTC failed to put a precise number on the benefit of data collection in preventing future financial crises. But the law does not require agencies to measure the immeasurable. CFTC's discussion of unquantifiable benefits fulfills its statutory obligation to consider and evaluate potential costs and benefits . . . . Where Congress has required "rigorous, quantitative economic analysis," it has made that requirement clear in the agency's statute, but it imposed no such requirement here.[99]

Like the CFTC's obligation under the CEA, the Commission's duty under the securities laws stands in sharp contrast to the statutory provisions in which Congress explicitly mandates a netting or specific balancing of costs and benefits, let alone mentions "costs" and "benefits."

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95 Better Markets has set forth a comprehensive analysis regarding the scope of the Commission's duties under the securities laws in 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. In addition, Better Markets has recently filed an *amicus curiae* brief in support of the Commission on the agency's statutory duties in *American Petroleum Inst. v. Commission*, No. 12-1398 (D.C. Cir. Oct. 10, 2012). Both the report and *amicus* brief are incorporated by reference as if fully set forth herein.

96 *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).

97 *See Whitman v. American Trucking Ass'ns., Inc.*, 531 U.S. 457, 471 (2001) (holding that a statute "unambiguously bars cost considerations"); *see also Nat'l Ass'n of Home Builders v. EPA*, 682 F.3d 1032, 1039 (D.C. Cir. 2012) (statutes in which agencies must "consider" the "economic" impact or "costs" do not require cost-benefit analysis); *Cent. Ariz. Water Conservation Dist. v. EPA*, 990 F.2d 1531, 1542 n.10 (9th Cir. 1993) (language in 42 U.S.C. § 7491(g)(1) requiring "consideration" does not require a cost-benefit analysis).

98 *Inv. Co. Inst. v. CFTC*, No. 1:12-cv-00612 (D.C. Cir. June 25, 2013)

99 *Id.* at 14-15 (cited authorities omitted).

Moreover, Congress's careful choice of words in Sections 3(f) and 23(a)(2) and the case law construing similar provisions, make clear that the Commission has broad discretion in discharging its duty. 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.[100]

The plain fact is that the Commission has no statutory or other obligation[101] to quantify costs or benefits,[102] weigh them against each other,[103] or find that a rule will confer a net benefit before promulgating it. The rationale for this flexible obligation in the law is clear: Requiring the Commission to conduct a resource intensive, time consuming, and inevitably imprecise cost-benefit analysis as a precondition to rulemaking would significantly impair the agency's ability to implement Congress's regulatory objectives.

The industry's desire to have its costs prioritized over all other costs (what they falsely refer to as "cost-benefit analysis") does not change the law, the rationale for the law, or the underlying policy.

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

[101] Indeed, there is no other law which would subject the Commission to a cost-benefit duty. The APA does not require such an analysis, *Vill. of Barrington v. Surface Transp. Bd.*, 636 F.3d 650, 670-671 (D.C. Cir. 2011), and the Executive Orders on cost-benefit analysis exclude the Commission and other independent agencies, Executive Order 13,579, 76 Fed. Reg. 41,587 (July 14, 2011); Executive Order No. 13,563, 76 Fed. Reg. 3,821, § 7 (Jan. 21, 2011); Executive Order 12,866, 58 Fed. Reg. 51,735, § 3(b) (Oct. 4, 1993).

[102] *Cf.* 42 U.S.C. § 300g-1(b)(3) (imposing a duty on the Environmental Protection Agency to use analysis of specific factors including the "[q]uantifiable and nonquantifiable health risk reduction benefits," the "[q]uantifiable and nonquantifiable costs," and "[t]he incremental costs and benefits associated with each alternative."). Courts have repeatedly held that an agency need not quantify the costs and benefits of a rule when a statute does not require it. *See, e.g., FMC Corp. v. Train*, 539 F.2d 973, 978-979 (4th Cir. 1976) (finding that 33 U.S.C. §§ 1314(b)(1)(B), (b)(2)(B) and § 1316 do not require quantification of the benefits in monetary terms). In fact, the D.C. Circuit has explicitly recognized that even in a cost-benefit analysis an agency's "predictions or conclusions" do not necessarily need to be "based on a rigorous, quantitative economic analysis." *Am. Fin. Services Ass'n. v. FTC*, 767 F.2d 957, 986 (D.C. Cir. 1985); *see also Pennsylvania Funeral Directors Ass'n v. FTC*, 41 F.3d 81, 91 (3d Cir. 1994) (recognizing that "much of a cost-benefit analysis requires predictions and speculation, in any context," and holding that the "absence of quantitative data is not fatal").

[103] Even when a statute refers to "costs" and "benefits," Courts refuse to impose a duty to conduct cost-benefit analysis absent language of comparison in the statute. *See Weyerhaeuser Co. v. Costle,* 590 F.2d 1011, 1045 (D.C. Cir. 1978); *see also Am. Petroleum Inst. v. EPA*, 858 F.2d 261, 265 & n.5 (5th Cir. 1988); *Reynolds Metal Co. v. EPA*, 760 F.2d 549, 565 (4th Cir. 1985).

B. The Commission must be guided first and foremost by the public interest and the protection of investors as it considers the economic impact of its rules, not by concerns over the costs of regulation imposed on industry.

The SEC's preeminent duty when promulgating rules is to protect investors and the public interest. The agency was established for the purpose of implementing the securities laws, and therefore its primary duty is to achieve the legislative objectives of those laws, which are first and foremost to protect investors and the public interest from fraud, abuse, and manipulation in the securities markets. As is evident from the securities laws themselves, their legislative history, and the specific delegations of rulemaking authority, the public interest and protection of investors is a key consideration in the SEC's rulemaking process. Indeed, Section 3(f) of the Exchange Act explicitly refers to "the protection of investors" and "the public interest," but does not mention any industry-focused concerns, such as compliance costs or the feasibility of conforming to rule requirements.[104]

The Commission's duty to protect investors and the public interest has renewed importance in light of the 2008 financial crisis. The financial crisis is a powerful reminder of the need to remain focused on the core purposes of securities regulation and the Commission's overriding duty to protect the public, investors, and the integrity of the markets. The Supreme Court's admonition about the importance of raising standards of conduct to the highest possible level following the Great Depression applies with equal force today:

> It requires but little appreciation . . . of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry.[105]

If these goals are subordinated to industry concerns over the costs of regulation in the rulemaking process, then the reforms embodied in the Dodd-Frank Act will have little chance of protecting our markets and our economy from the ravages of another financial crisis. Thus, in promulgating rules under the Dodd-Frank Act, the Commission must be guided by the preeminent concerns of the public interest and the protection of investors, not the burdens of regulation on industry.

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104 *Cf.* 42 U.S.C. § 300g-1(b)(3)(C) (requiring analysis of certain costs of safe drinking water regulations including costs that "are likely to occur solely as a result of compliance with the maximum contaminant level, including monitoring, treatment, and other costs"); 42 U.S.C. § 6295(d) (1976 ed., Supp. II) (requiring a weighing of the economic impact on manufacturers and the savings in operating costs as "compared to any increase in the price of, or in the initial charges for, or maintenance expenses of, the covered products which are likely to result").

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

C. For any rule promulgated in accordance with and in furtherance of the Dodd-Frank Act, the ultimate public interest and investor protection consideration is implementing the reforms that Congress passed to provide for a safer and sounder financial system and to prevent another financial crisis.

The statutory authority for the Proposal is the Dodd-Frank Act. The Commission must therefore consider and give proper weight to the overriding goal that Congress intended to achieve when it passed that comprehensive, interrelated law, and in terms of the enormous benefit that the rules collectively will provide to the public. That goal is to prevent another financial collapse and economic crisis, and that benefit is to avoid the economic costs, hardships, and human suffering that would inevitably accompany such disastrous events.

The dollar cost alone of the financial collapse and still-unfolding economic crisis is conservatively estimated to be in the trillions. A study by Better Markets estimates that those costs will exceed $12.8 trillion.[106] In addition, the Government Accountability Office has recently issued the results of a study on the costs of the crisis, observing that "the present value of cumulative output losses [from the crisis] **could exceed $13 trillion**."[107] Therefore, as the Commission 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.

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

However, the financial reform law and the rules implementing it do not, in fact, add any incremental costs (or, if they do, those costs are *de minimis*). Rather, they reallocate costs so that industry bears them in a regulated environment that **prevents**

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[106] *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.

[107] 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).

financial failure and bailouts. As a result, the public and society are spared the massive costs of responding to economic crises after the fact.[108]

Congress fully understood this. It knew that re-regulation would impose costs on the industry, in some cases totaling billions of dollars. The Dodd-Frank Act reflects Congress's unflinching determination to shift the costs of de-regulation and non-regulation of the financial industry back to the industry from a society that has paid and continues to pay the bill for industry's unregulated excesses. In substance, Congress conducted its own cost-benefit analysis and concluded that the enormous collective benefits of the law far exceeded the costs and lost profits that industry would have to absorb.[109]

Indeed, had Congress wanted the financial regulatory agencies to conduct cost-benefit analysis prior to promulgating the rules under the Dodd-Frank Act, it would have clearly said so. Congress passed the Dodd-Frank Act fully aware of the specific economic analysis provisions in the federal agencies' governing statutes—like Sections 3(f) and 23(a)(2) of the Exchange Act—and fully aware of how to impose a cost-benefit analysis requirement. Yet, it made no changes to those provisions, thereby affirming congressional intent that those specific provisions should control as they were originally written and intended.

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.

In short, the following analytical framework must guide any consideration of the economic impact of rules implementing the Dodd-Frank Act, or any rules that are promulgated within the broader Dodd-Frank Act context:

- Congress's ultimate objective in the Dodd-Frank Act was to prevent another crisis and the massive costs it would inflict on our financial system, taxpayers, investors, economy, and country;

- The Proposal is an integral component of the overall body of reforms that Congress envisaged to achieve this objective; and

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108 *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.

109 *Id.* at 43.

- The costs of compliance and reduced profits that industry may have to absorb by virtue of the Proposal, as well as the entire Dodd-Frank Act, were considered by Congress in passing the law and determined to pale in comparison with the benefits of preventing another crisis—a benefit that can be valued at over $12.8 trillion.

D. The Commission must ensure that its economic analysis is limited to its narrow duty under Sections 3(f) and 23(a)(2), and that it does not undertake a cost-benefit analysis.

With respect to the Proposal, the Commission must simply identify the statutory provisions applicable to its economic considerations and explain how various aspects of the Rules would affect the specifically enumerated factors in those provisions. This is what the Exchange Act requires, and by considering the specified factors, the SEC will fulfill its duty with respect to economic analysis.

Conversely, the Commission should 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. This type of analysis is not required by Sections 3(f) and 23(a)(2), it poses a threat to the implementation of Congress's policy goals, and it wastes agencies' resources without producing accurate or useful results. In fact, consideration of costs and benefits beyond those specifically tied to the Exchange Act provisions misleads the public and the Commission by presenting an inevitably incomplete and inaccurate portrayal of a rule's impact, and by overemphasizing easily quantifiable costs to the detriment of vastly more important, albeit unquantifiable, benefits.

At a minimum, 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. And, assuming that particular costs and benefits are at all relevant to the SEC's required economic analysis, the agency should more clearly set forth how those costs and benefits are directly related to protecting investors or the public or to efficiency, competition, or capital formation. Although the Release dedicates several pages to the SEC's consideration of efficiency, competition, and capital formation, it must also include and appropriately emphasize the SEC's consideration of the protection of investors and the public.

E. Finally, the Commission should explicitly set forth the fact that the rule is being proposed or adopted as part of a comprehensive, integrated framework aimed at preventing another financial crisis.

The context in which the Proposal is being promulgated, concurrently with the comprehensive overhaul of the entire SBS market under the Dodd-Frank Act, is extremely important and should be fully explained in connection with the consideration of the application of Sections 3(f) and 23(a)(2). The Release appropriately notes that "[i]n developing our approach to the application of Title VII to cross-border activities, we have focused on meeting the goals of Title VII, including the promotion of the financial stability of the United States by improving accountability and transparency in the U.S. financial system, the reduction of systemic risk, and the protection of counterparties to security-based swaps.[110] But, the SEC should emphasize the Dodd-Frank Act authority, and should explain that the Proposal is part of a comprehensive set of reforms that collectively will help avoid another devastating financial crisis.

This level of explanation is appropriate to illustrate the larger interests at stake: not only promoting a specific interest—such as transparency through data reporting—but also increasing the overall stability and integrity of the entire SBS marketplace, and ultimately reducing the likelihood of a future financial collapse and economic crisis.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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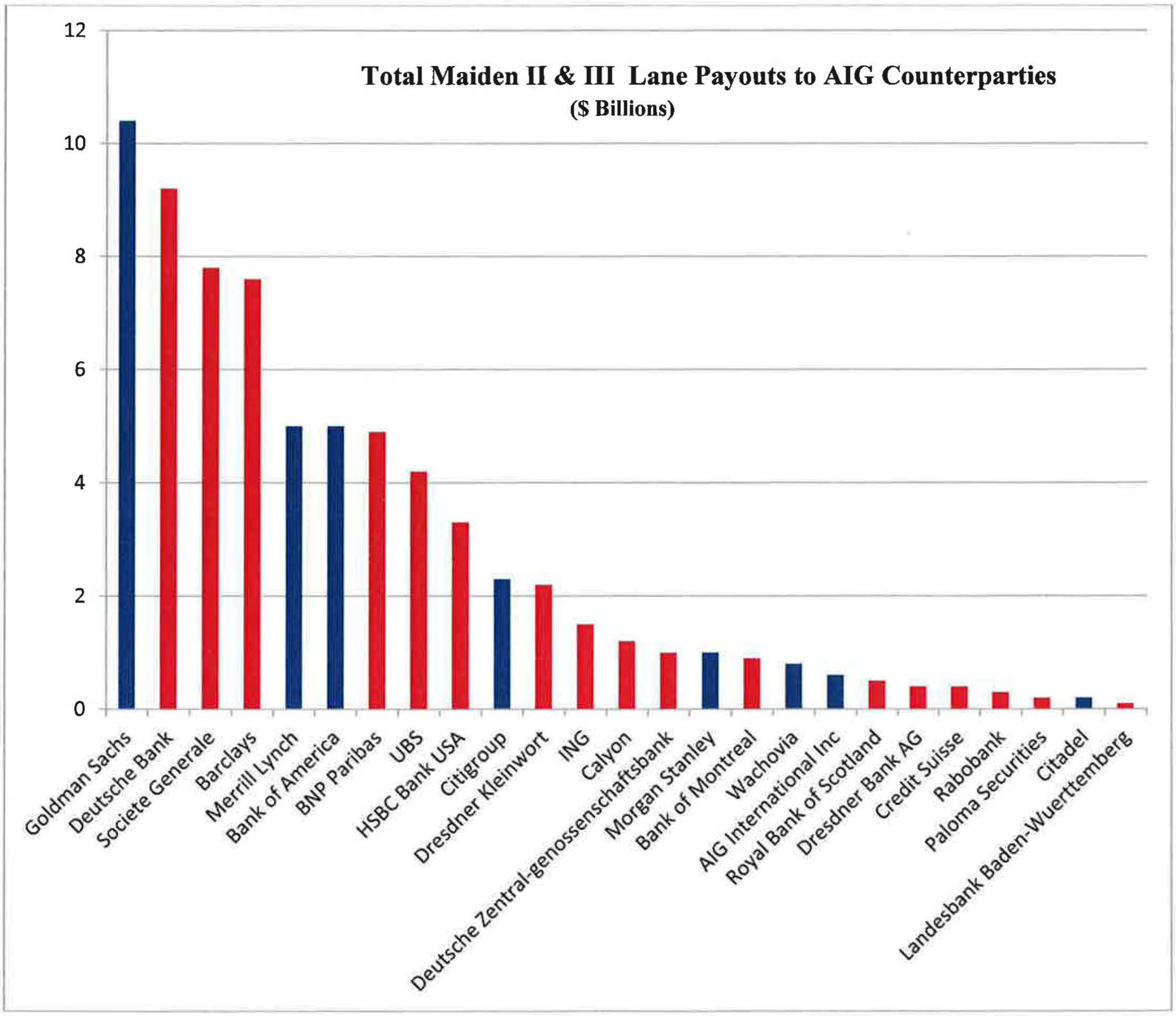
[110] 78 Fed. Reg. 31,126.

ADDENDUM

AIGFP risk came home to the U.S.

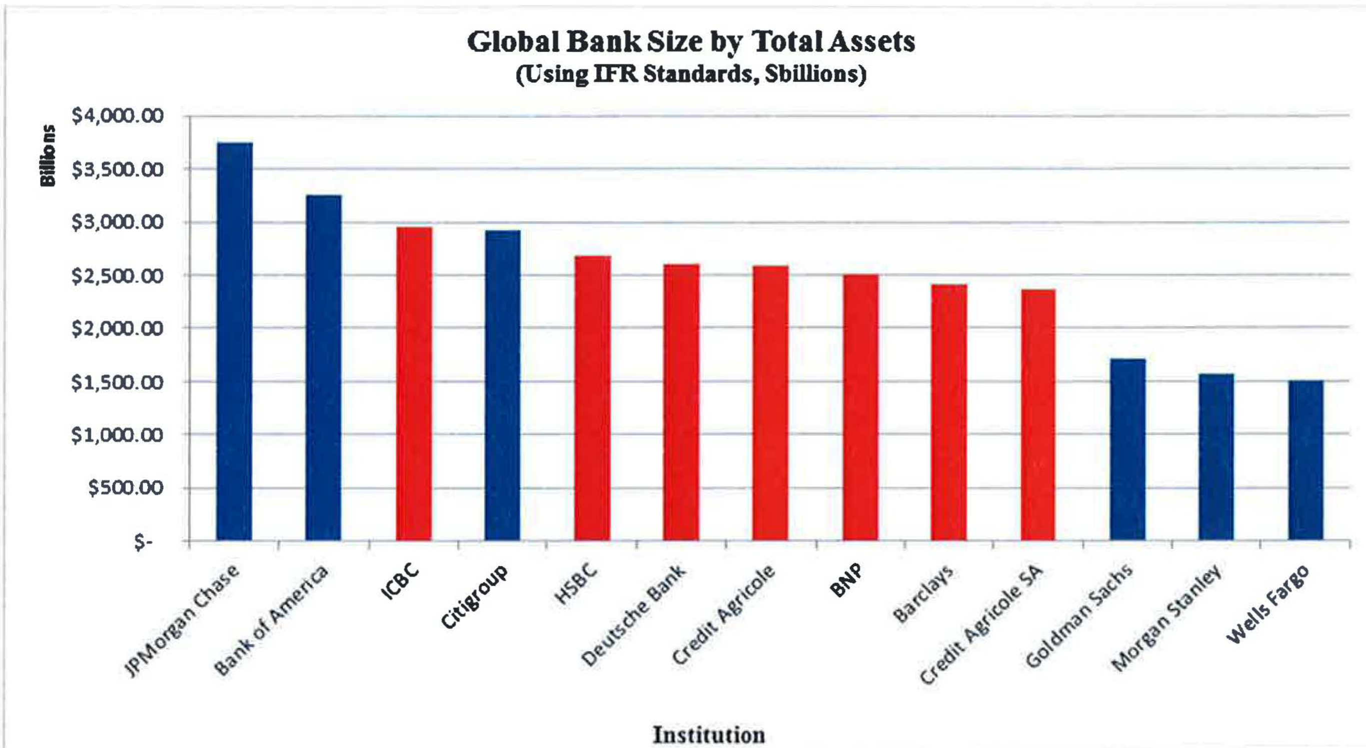
(blue U.S., red European)

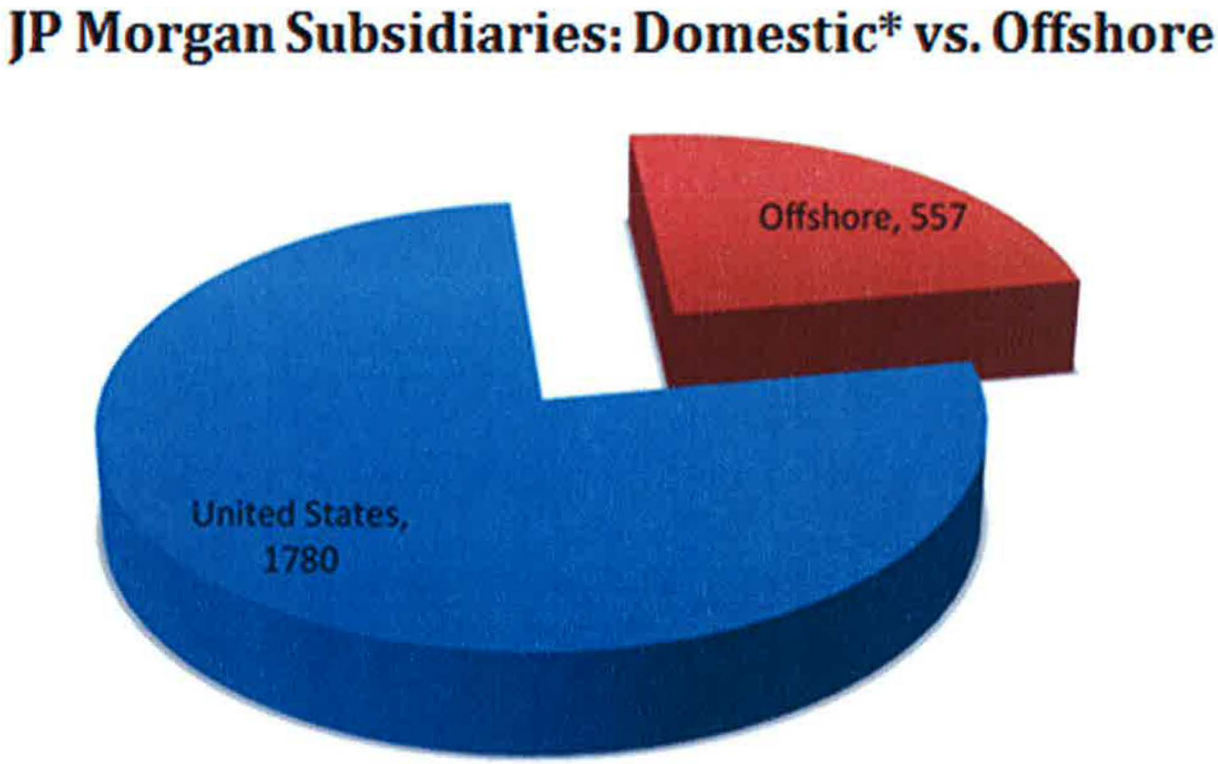


Ms. Elizabeth M. Murphy
Figure 2

Global Bank Size By Total Assets

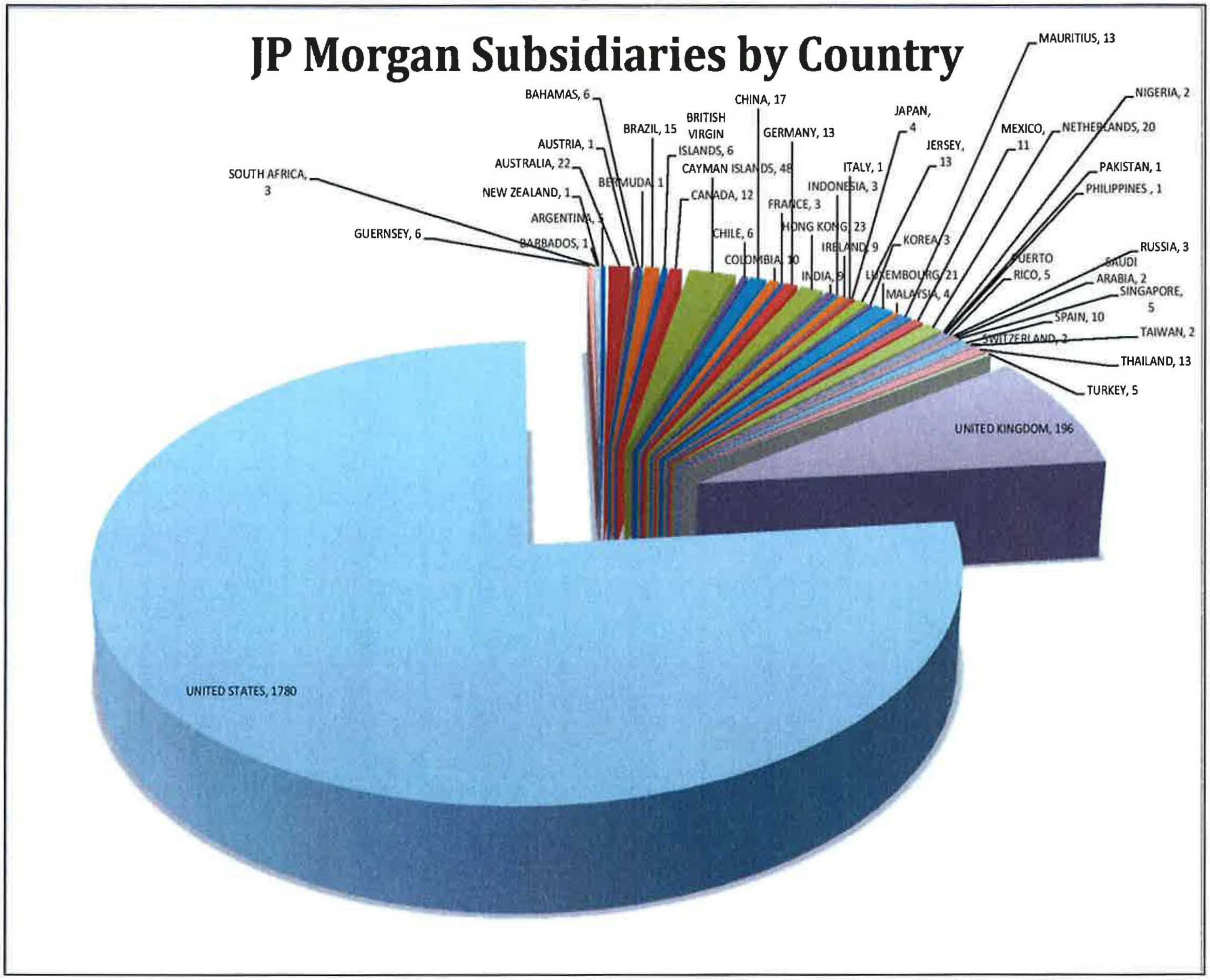
Largest banks in the world (blue U.S., red European)





*To avoid a misleading impression, the domestic number excludes 656 subsidiaries (all JPM Plymouth Park Tax Services, LLC entities) because they appear to be shell companies that exist solely to hold delinquent property tax liens used to foreclose on homes in the U.S.

Ms. Elizabeth M. Murphy
Figure 4



Ms. Elizabeth M. Murphy
Figure 5

JP Morgan Global Operations

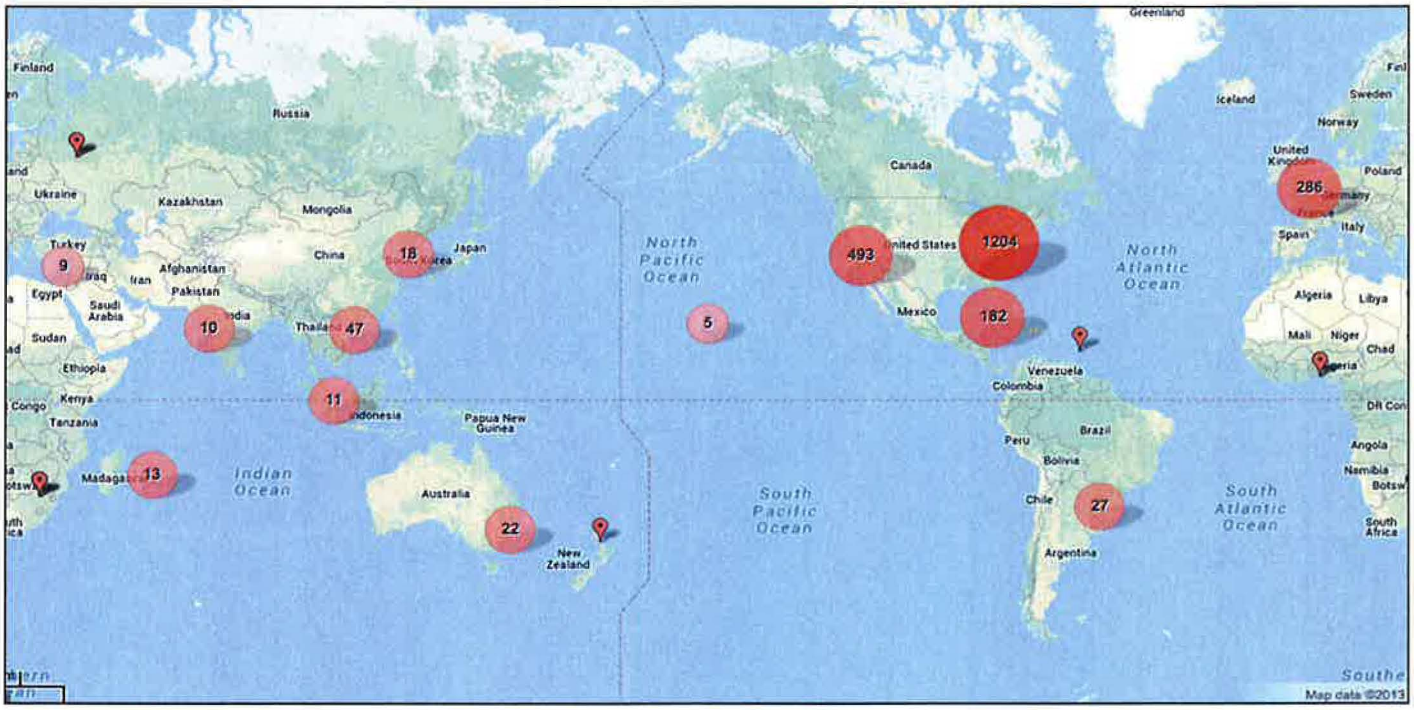


Figure 6

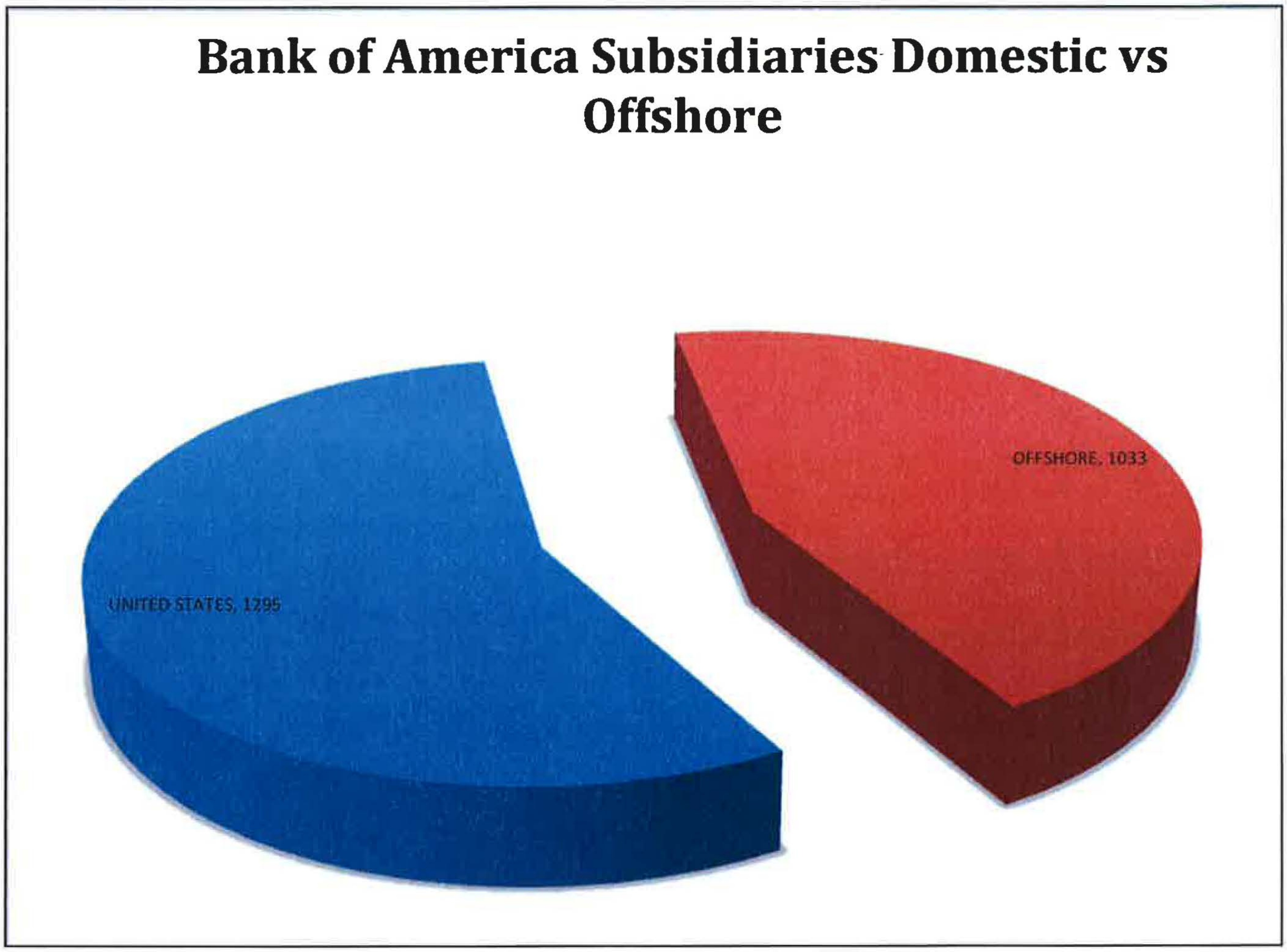
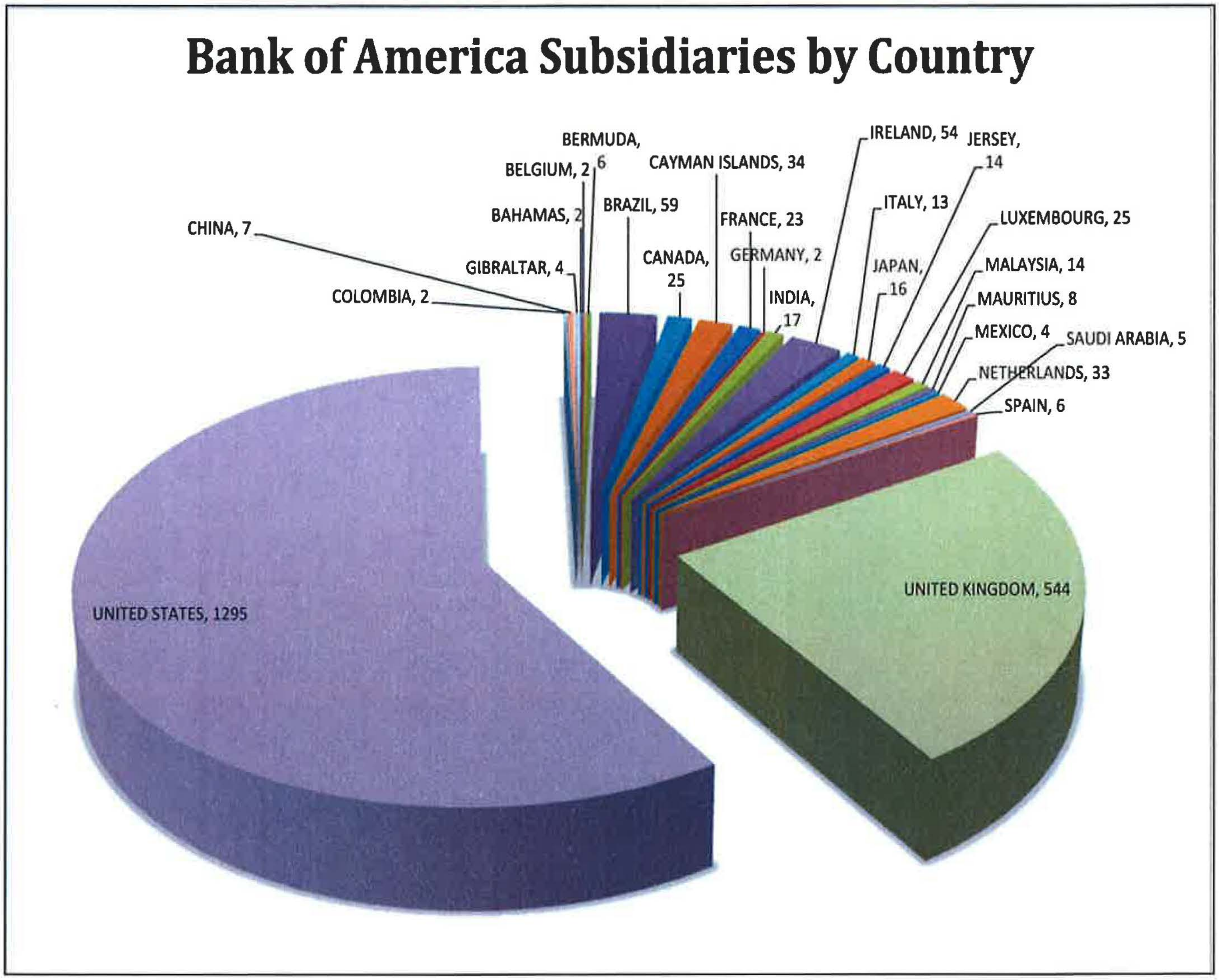
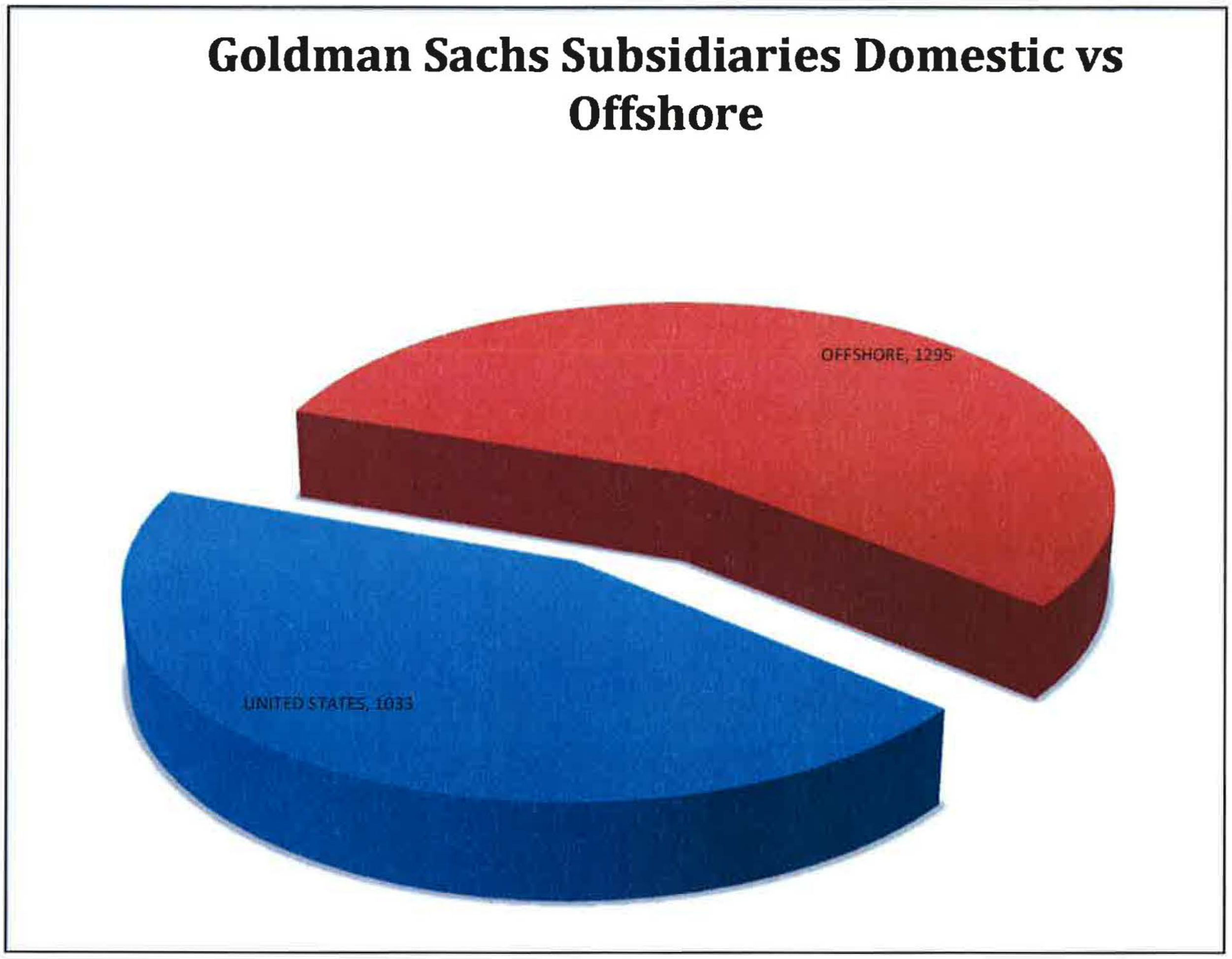

Bank of America Subsidiaries Domestic vs Offshore
OFFSHORE, 1033
UNITED STATES, 1295

Figure 7


Bank of America Subsidiaries by Country
BERMUDA, 6
BELGIUM, 2
CAYMAN ISLANDS, 34
IRELAND, 54
JERSEY, 14
BAHAMAS, 2
BRAZIL, 59
ITALY, 13
CHINA, 7
FRANCE, 23
LUXEMBOURG, 25
GIBRALTAR, 4
CANADA, 25
GERMANY, 2
JAPAN, 16
MALAYSIA, 14
COLOMBIA, 2
INDIA, 17
MAURITIUS, 8
MEXICO, 4
SAUDI ARABIA, 5
NETHERLANDS, 33
SPAIN, 6
UNITED KINGDOM, 544
UNITED STATES, 1295

Bank of America's European Operations

Figure 9


Goldman Sachs Subsidiaries Domestic vs Offshore
OFFSHORE, 1295
UNITED STATES, 1033

Ms. Elizabeth M. Murphy
Figure 10

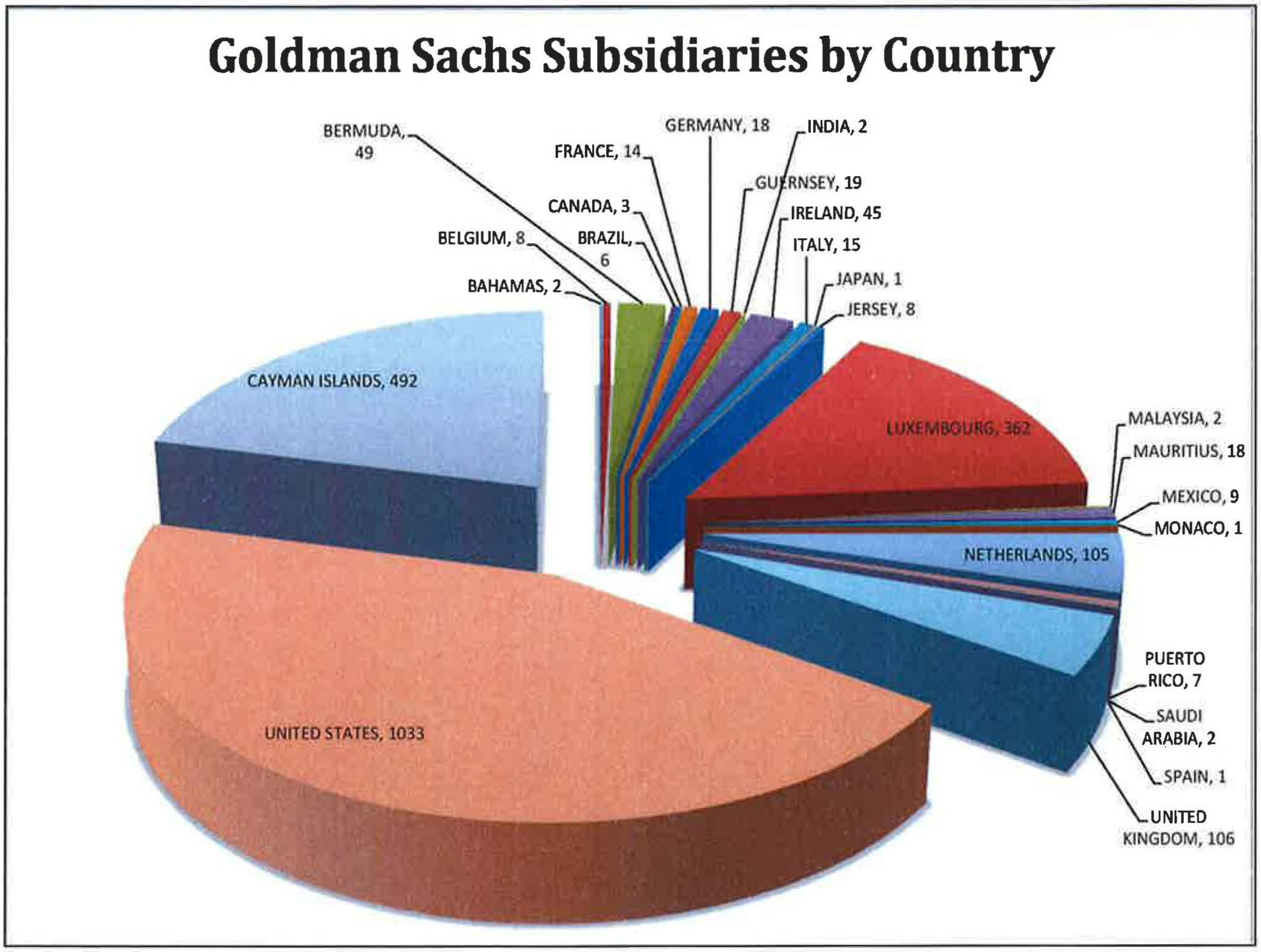
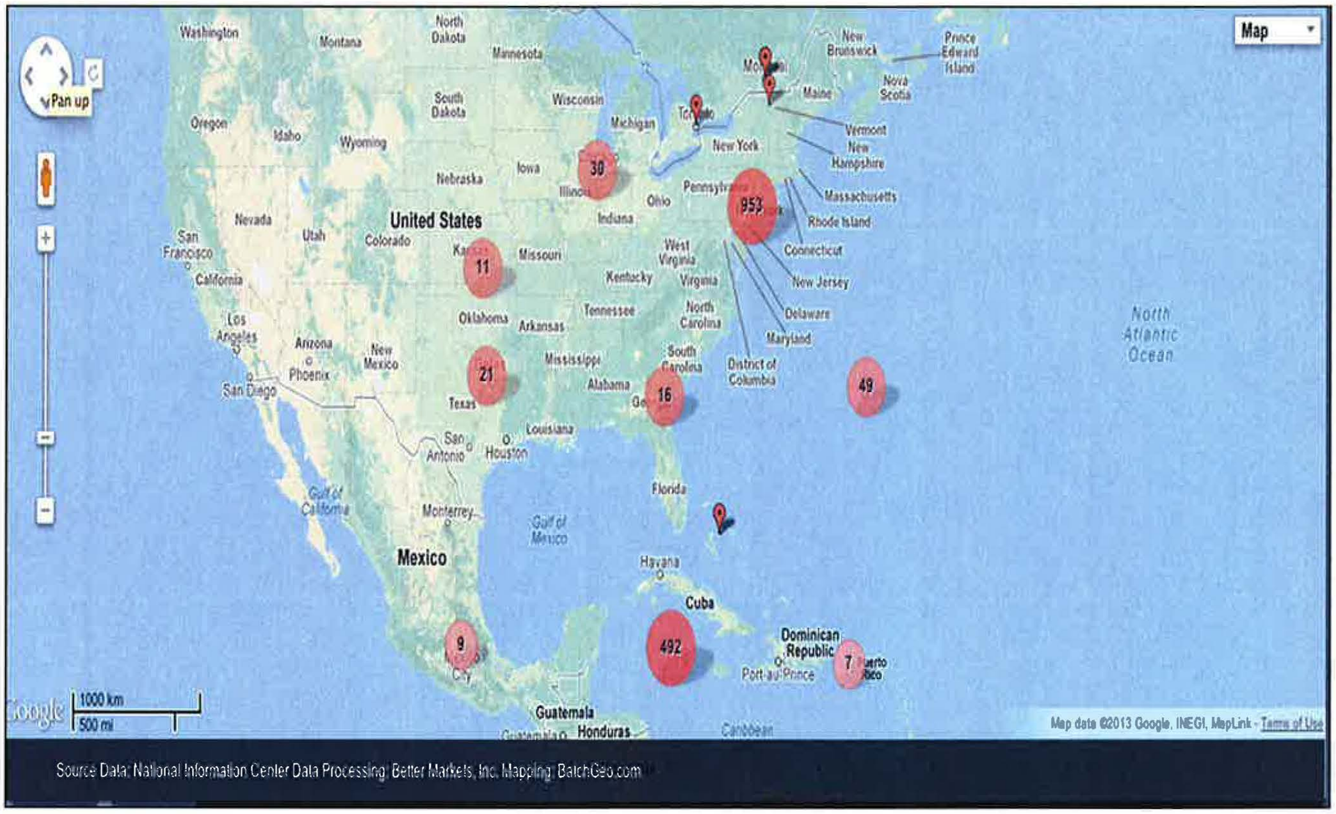
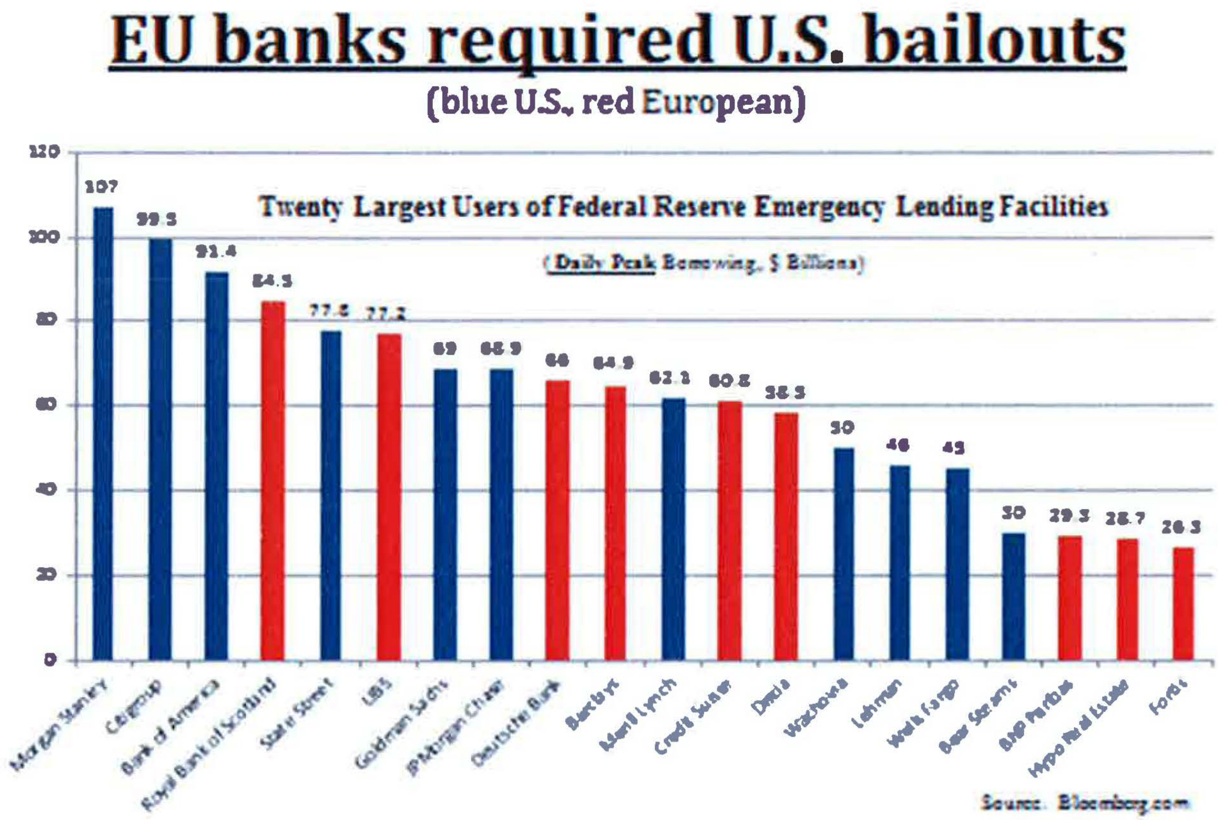


Figure 11

Goldman's North America Operations



Ms. Elizabeth M. Murphy
Figure 12



Ms. Elizabeth M. Murphy
Figure 13

Fed lending to Royal Bank of Scotland (RBS)

Royal Bank of Scotland Group Plc

$84.5B
Peak Amount of Debt on 10/10/2008

661
Number of Days In Debt to the Fed

$21.4B
Average Daily Balance From 8/1/2007 to 4/30/2010

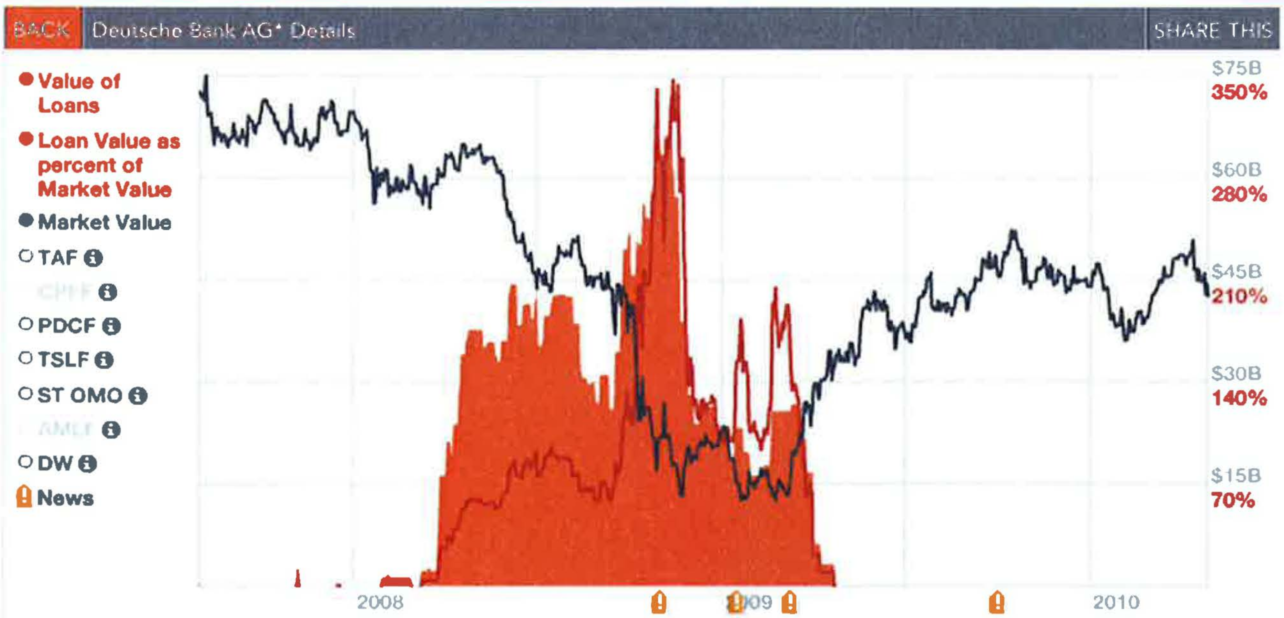
$74B
Capital Raised From Home Governments

*More Information

Royal Bank of Scotland Group Plc, whose 45.5 billion-pound ($74 billion) emergency capital injection from U.K. taxpayers was the world's biggest announced bank bailout, also got more secret loans from the U.S. Federal Reserve than any other foreign bank. On Oct. 10, 2008, as the bank's stock price plunged 21 percent in a single day, Edinburgh-based RBS was borrowing $62.5 billion from the Fed through its U.S. broker-dealer, $11.5 billion through its New York branch, $10 billion through its RBS Citizens NA bank and $500 million through Citizens Bank of Pennsylvania. The Fed aid exceeded even the 36.6 billion pounds of emergency liquidity the Bank of England supplied in secret to RBS in October 2008. The BOE disclosed the aid package in November 2009, more than a year before the Fed aid was revealed.

Ms. Elizabeth M. Murphy
Figure 14

Fed lending to Deutsche Bank



Deutsche Bank AG

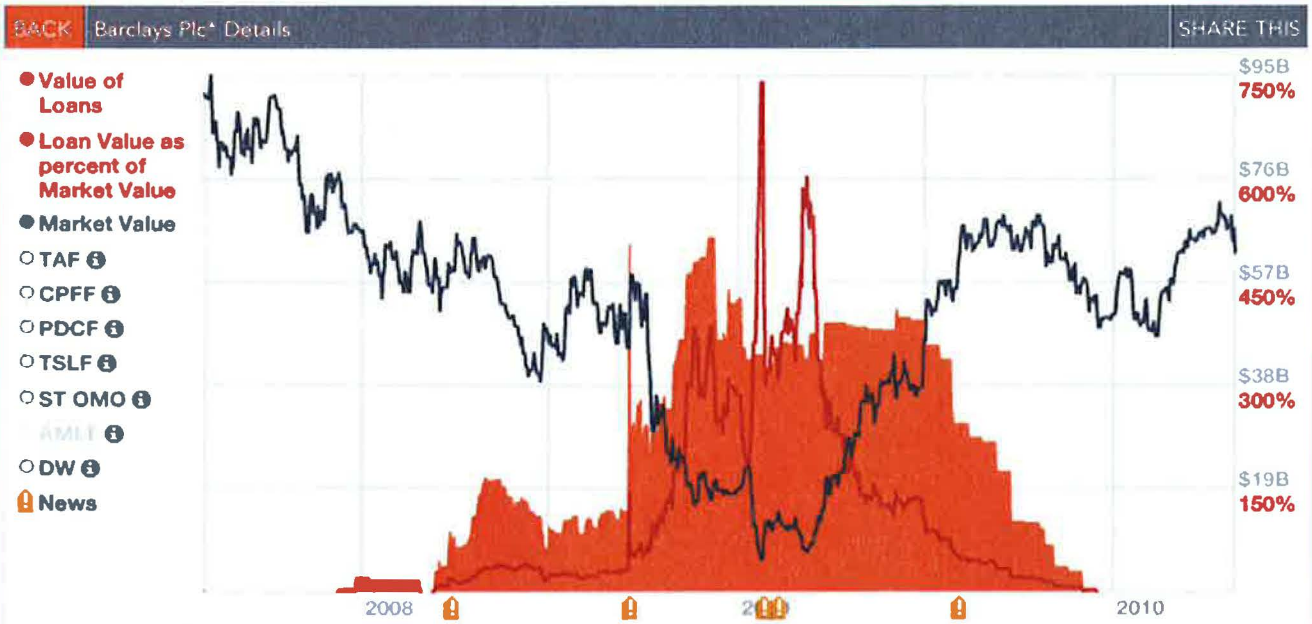
$66B
Peak Amount of Debt on 11/6/2008

439
Number of Days In Debt to the Fed

$12.5B
Average Daily Balance
From 8/1/2007 to 4/30/2010

Deutsche Bank AG, Germany's biggest bank, navigated the financial crisis without capital injections from the German government. The Frankfurt-based bank, which in 2008 reported its first annual loss since World War II, wasn't so shy about getting liquidity in secret from the U.S. Federal Reserve. The lender tapped the Fed for $66 billion on Nov. 6, 2008 -- $28.2 billion from the Term Securities Lending Facility, $21.8 billion from single-tranche open market operations and $16 billion from the Term Auction Facility. John Gallagher, a Deutsche Bank spokesman, declined to say whether the bank took emergency loans during the crisis from other central banks, such as Germany's Bundesbank.

Fed lending to Barclays



Barclays Plc

$64.9B
Peak Amount of Debt on 12/4/2008

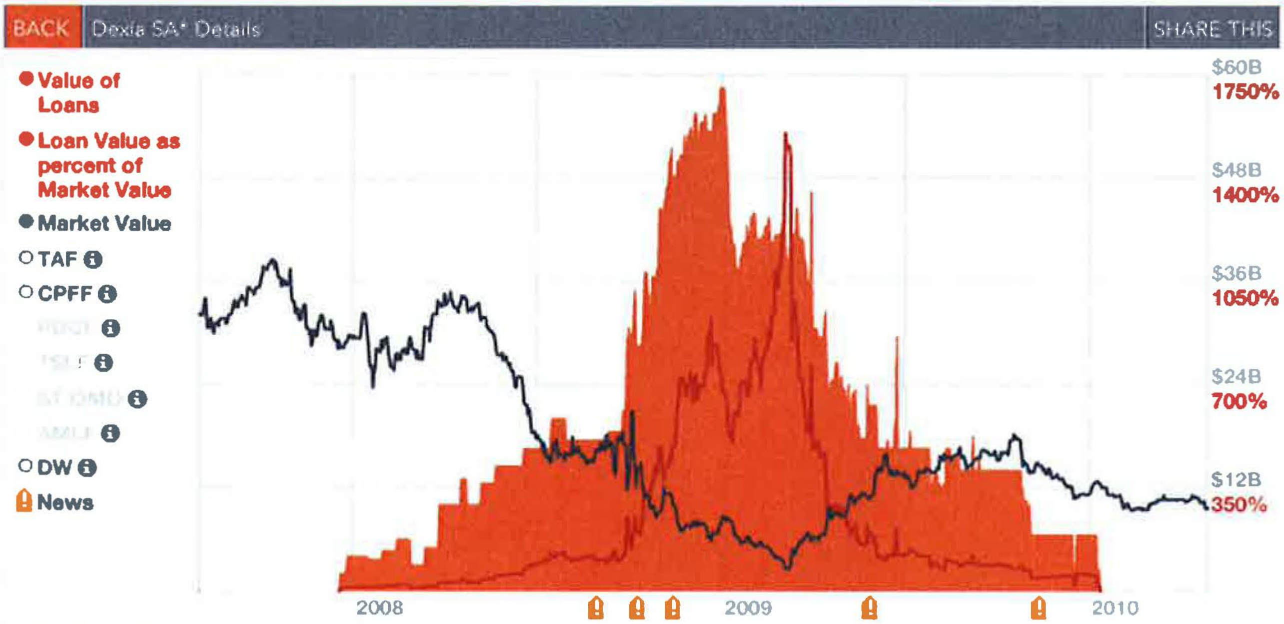
724
Number of Days in Debt to the Fed

$19.1B
Average Daily Balance
From 8/1/2007 to 4/30/2010

*More Information

"There was not a direct subsidy to Barclays" from governments during the financial crisis, Chief Executive Officer Robert Diamond told a U.K. House of Commons hearing in London on June 8, 2011. While the company avoided taking government capital, it was more accepting of emergency cash from the U.S. Federal Reserve. Data show that the London-based bank borrowed $64.9 billion from the Fed on Dec. 4, 2008, more than two months after it agreed to buy the North American unit of Lehman Brothers Holdings Inc. in a bankruptcy auction. The London-based bank was still borrowing more than $40 billion from the Fed as late as June 2009, nine months after the Lehman deal closed. Sarah MacDonald, a Barclays spokeswoman, declined to say whether the bank also got liquidity from the Bank of England.

Fed lending to Dexia SA



Dexia SA

$58.5B
Peak Amount of Debt on 12/31/2008

756
Number of Days In Debt to the Fed

$15.5B
Average Daily Balance From 8/1/2007 to 4/30/2010

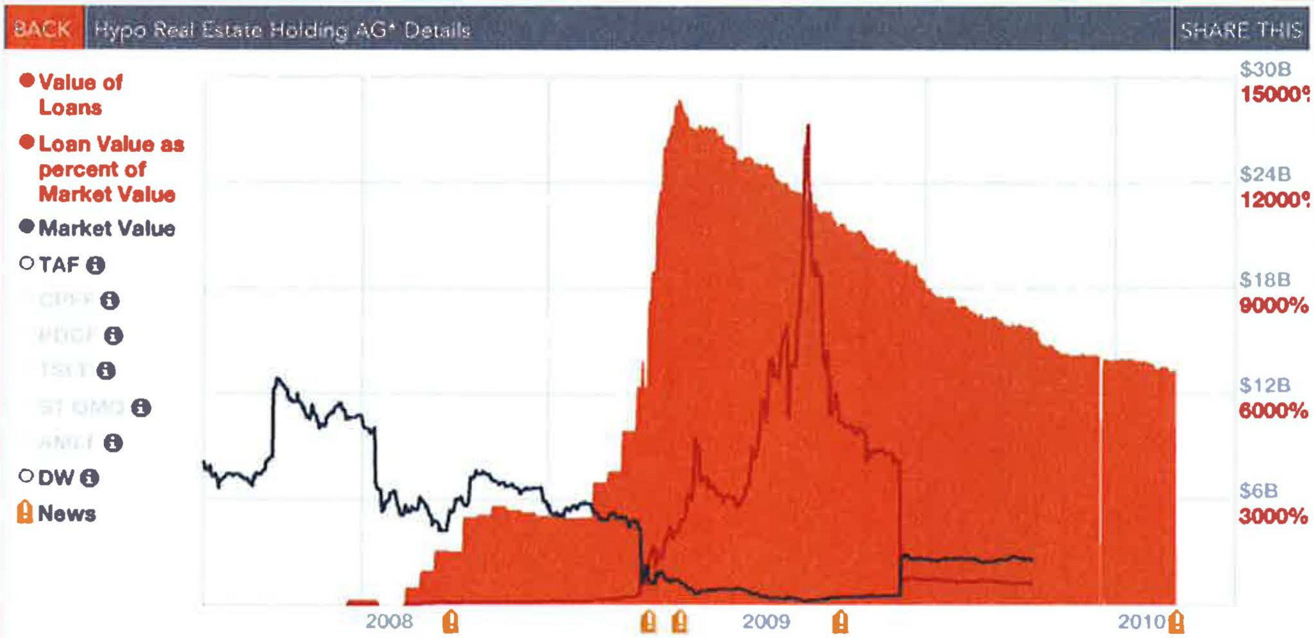
$7.3B
Capital Raised From Home Governments

*More Information

The biggest U.S. banks avoided the discount window, the Federal Reserve's 97-year-old last-resort lending facility, partly out of concern that tapping it might brand them as weak. Dexia SA, a lender to local governments in Belgium, showed no such reservation. The bank, based in Brussels and Paris, was the discount window's biggest borrower during the crisis, tapping it for $37 billion in December 2008. Dexia simultaneously borrowed $21.5 billion from temporary Fed programs that were primary sources of emergency funding for U.S.-based Citigroup Inc., Bank of America Corp. and JPMorgan Chase & Co. In all, Dexia owed about 120 billion euros ($168 billion) to central banks at the end of 2008. As of June 30, 2011, it still had 34 billion euros of central-bank funding.

Ms. Elizabeth M. Murphy
Figure 17

Fed lending to Hypo Real Estate Holding



Hypo Real Estate Holding AG

$28.7B
Peak Amount of Debt on 11/4/2008

772
Number of Days In Debt to the Fed

$11.1B
Average Daily Balance From 8/1/2007 to 4/30/2010

$14B
Capital Raised From Home Governments

*More Information

Hypo Real Estate Holding AG, a German commercial-property lender with 1,366 employees, borrowed as much as $28.7 billion in November 2008 from the U.S. Federal Reserve through the New York branch of its Depfa Bank Plc unit. That's about $21 million per employee. It borrowed almost one-third as much as Citigroup Inc., which has 190 times as many employees. The Fed aid came in addition to 142 billion euros ($206 billion) of emergency credit lines and debt guarantees from German authorities. Hypo, which invested in mortgage-backed securities in the years before the financial crisis, said in a 2009 report that it lost access to short-term funding after Lehman Brothers Holdings Inc.'s bankruptcy. Hypo didn't disclose any Fed borrowings until the loans became public in 2011.

EU bank regulation totally failed
Foreign depositors, taxpayers, and treasuries

EU Banks rescued by their governments during the crisis

U.K.	Germany
Northern Rock *	West LB
Royal Bank of Scotland *	Landesbank Baden Wurttemberg
Lloyds Banking Group	IKB
Bradford and Bingley *	Hypo Real Estate *
HBOS	Nord LB
	Commerzbank AG

Belgium	Netherlands
Dexia *	ING
KBC Group	SNS REAAL
Fortis	

France	Sweden
Caisse d'Espargne/Bansque Populaire	Carnegie Bank *

Ireland	Switzerland
Anglo Irish Bank *	UBS

Source: Centre for European Policy Studies (2010), Bank State Aid in the Financial Crisis, October

*government majority ownership