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# THE U.S. APPROACH TO SWAPS REGULATION: STRIKING A BALANCE BETWEEN DOMESTIC AND FOREIGN INTERESTS

Julia H. Iodice\*

## INTRODUCTION

The swaps market, a market where financial instruments are backed by cash flow agreements, has become a major concern for both domestic and international governments because of its ability to adversely impact the world's financial security.<sup>1</sup> The more than \$600 trillion swaps market<sup>2</sup> has become the focus of government intervention and public attention as financial markets struggle to emerge from the worst crisis since the Great Depression.<sup>3</sup> Although swaps played an integral role in the collapse of Lehman Brothers, and negatively impacted a number of other global financial institutions, the fall of American International Group, Inc. ("AIG") in September 2008 is the most prominent example of how destructive swaps were during the financial crisis.<sup>4</sup> AIG's \$526 billion portfolio of credit default swaps was the key factor that led to its demise.<sup>5</sup> Prior to the

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<sup>1</sup> A swap is a type of derivative financial instrument involving an exchange of cash flows that are dependent upon some other factor such as currency exchange rates or the underlying price of a commodity. The Commodity Exchange Act provides an extensive definition of the term in §1a(47)(A). 7 U.S.C.A. § 1a(47)(A).

<sup>2</sup> Carla Main, *Swaps Rules, U.A.E. Debt, Basel Deadline: Compliance*, BLOOMBERG (Oct. 12, 2012, 8:34 AM), <http://www.bloomberg.com/news/2012-10-12/swaps-rules-u-a-e-debt-basel-deadline-compliance.html>.

<sup>3</sup> Gary Gensler, Chairman, U.S. Commodities Futures Trading Comm'n, *The New Era of Swaps Market Reform – Keynote Address before the George Washington University Center for Law, Economics and Finance Conference* (Oct. 10, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-124>).

<sup>4</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, 77 Fed. Reg. 41214, 41215 (proposed Jul. 12, 2012).

<sup>5</sup> William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 945 (2009).

collapse, AIG had a global presence with businesses in 130 countries.<sup>6</sup> Experts speculated that because AIG's market share of the swaps industry was so vast and globally connected, its inability to satisfy its credit default swap claims could have caused a "domino effect of failures" to spread to other institutions around the world.<sup>7</sup> In September 2008, concern over the disastrous effect that AIG's bankruptcy would have on the global financial markets prompted the United States government to make an unprecedented loan to AIG, totaling more than \$85 billion dollars, to prevent the insurance giant from defaulting on its obligations.<sup>8</sup> Subsequent cash infusions from the federal government were made as AIG continued to falter, bringing the final amount of the bailout up to \$182 billion.<sup>9</sup> While many institutions accepted government bailout money during the financial crisis, AIG's bailout was considered to be "the most loathed of the rescues."<sup>10</sup>

In the wake of the 2008 crisis, U.S. regulators began implementing reforms to the existing regulatory framework in order to address systemic risks and prevent future economic crises of the magnitude experienced over the last few years.<sup>11</sup> The Dodd-Frank Consumer Protection and Wall Street Reform Act ("Dodd-Frank"), signed into law by President Barack Obama on July 21, 2010, was intended to remedy "the deficiencies in the regulatory system that contributed to the financial crisis."<sup>12</sup> However, the global nature of the financial industry has added a layer of complexity to developing an improved regulatory scheme. As the Commodity Futures Trading Commission (the "CFTC") has

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<sup>6</sup> Monica Langley, et al., *Bad Best and Cash Crunch Pushed Ailing AIG to Brink*, WALL ST. J. (Sept. 18, 2008).

<sup>7</sup> Sjoström, Jr., *supra* note 5, at 978.

<sup>8</sup> *Id.* at 976; *see also* Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41215.

<sup>9</sup> Michael J. De La Merced & Ben Protess, *A.I.G. Says It Will Not Join Lawsuit Against Government*, N.Y. TIMES DEALBOOK, at B1 (Jan. 10, 2013).

<sup>10</sup> Andrew Ross Sorkin, *Plot Twist in the AIG Bailout: It Actually Worked*, N.Y. TIMES DEALBOOK, at B1 (Sept. 10, 2012) (The AIG bailout was the largest of its kind in United States history and was predicted to result in heavy losses for the federal government. This prompted a very critical public response).

<sup>11</sup> *See* The Dodd-Frank Consumer Protection and Wall Street Reform Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376.

<sup>12</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41216; *see also* Troy S. Brown, *Legal Political Moral Hazard: Does the Dodd-Frank Act End Too Big to Fail?*, 3 ALA. C.R. & C.L.L. REV. 1, 1 (2012).

asserted, “corporate structures and inter-affiliate obligations may cause the activity, regardless of where that activity took place, to have a direct and significant connection with activities in, or effect on commerce in the U.S.”<sup>13</sup>

AIG once again exemplifies this issue. The swaps transactions that brought down AIG were entered into by one of its subsidiaries, AIG Financial Products.<sup>14</sup> Although it was headquartered in the United States, AIG Financial Products was largely operated in London and traded through a French bank, Banque AIG.<sup>15</sup> The substantial losses AIG Financial Products suffered from these transactions caused the credit rating downgrade of AIG because AIG was a guarantor of its subsidiary’s swaps.<sup>16</sup> This in turn resulted in collateral calls and a liquidity crisis for the parent corporation.<sup>17</sup>

The events surrounding AIG’s failure illustrate the nature in which the financial industry functions and transacts across national borders, and how these activities in foreign jurisdictions can profoundly affect the U.S. economy, and vice versa.<sup>18</sup> As CFTC Chairman Gary Gensler stated, “During a default or crisis, risk knows no geographic border.”<sup>19</sup> The danger that negative effects will spread across national economies is particularly prevalent in the swaps industry given that swaps transactions often involve parties who are domiciled in different countries and, for much of their existence, have gone generally unregulated as opaque over-the-counter transactions.<sup>20</sup> Accordingly, U.S. policymakers and regulators have made swaps a priority of the post-financial crisis reforms.

The U.S. was not alone in identifying regulatory deficiencies with respect to swaps and derivatives in general. Prior

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<sup>13</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41215–41216.

<sup>14</sup> *Id.* at 41215.

<sup>15</sup> *Id.*

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *See id.* (discussing the billion dollar trading loss that U.S. bank J.P. Morgan suffered due to activity in its London office).

<sup>19</sup> Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm’n, Address Securities Industry and Financial Markets Association’s 2012 Annual Meeting (Oct. 23, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-125>).

<sup>20</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41216.

to 2008, the European Union, along with countries such as Canada and Japan, generally did not regulate swaps.<sup>21</sup> However, in the aftermath of the global financial crisis, the international community agreed that the swaps industry needed oversight and increased transparency.<sup>22</sup> At the 2009 G20 Summit in Pittsburgh, members expressed a commitment to regulate the over-the-counter (“OTC”) derivatives industry in the following three ways:<sup>23</sup> (1) OTC derivatives contracts should be reported to trade repositories; (2) all standardized OTC derivatives contracts should be cleared through central counterparties and traded on exchanges or electronic trading platforms, where appropriate, by the end of 2012; and (3) non-centrally cleared contracts should be subject to higher capital requirements.<sup>24</sup> The first requirement will provide greater transparency by aggregating data at trade repositories. The call for centralized clearing is a direct response to the AIG collapse as it is intended to avoid the concentration of risk within large institutions that are heavily interconnected with other institutions both domestically and internationally.<sup>25</sup> Instead, the risk will lie with the clearinghouses,<sup>26</sup> which should be better positioned to handle it.<sup>27</sup> Mandatory clearing of swaps should also improve

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<sup>21</sup> Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm’n, Remarks before Ontario Securities Commission (OSC), OSC Dialogue 2012 in Toronto, Canada (Oct. 30, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-126>).

<sup>22</sup> Gensler, *supra* note 19.

<sup>23</sup> The G20, whose members represent 90% of global GDP, is a “forum for international cooperation” that seeks to coordinate policies to achieve and promote a stable global economy. The G20 includes Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Republic of Korea, Russia, Saudi Arabia, South Africa, Turkey, United Kingdom, United States, and the European Union. See *What is the G20?*, G20 (March 10, 2013), <http://www.g20.org/index.php>.

<sup>24</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41216.

<sup>25</sup> See Philip Stafford, *Blizzard of Regulation has its Effect*, FIN. TIMES (Oct. 29, 2012, 8:12PM), <http://www.ft.com/cms/s/0/3da86288-19d7-11e2-a179-00144feabdc0.html#axzz2DJIUDIZj>.

<sup>26</sup> A clearinghouse serves as an intermediary for counterparties to a transaction by acting as a buyer for the party looking to sell and a seller for the party looking to buy. Kristin N. Johnson, *Clearinghouse Governance: Moving Beyond Cosmetic Reform*, 77 BROOK. L. REV. 681, 693 (2012).

<sup>27</sup> *The Risk in Clearing Houses: All Clear?*, THE ECONOMIST (Apr. 7, 2012), <http://www.economist.com/node/21552209>; see also Matthew Leising, *Clearinghouses Should Divulge More Risk Information, Report Says*,

transparency, make it more difficult for a counterparty to avoid maintaining the required collateral, and offer insurance for a non-defaulting party.<sup>28</sup> Finally, higher capital requirements for uncleared swaps will ensure that the entities engaged in transactions without the protections of a clearinghouse have sufficient collateral to reduce the risk of default.

While the G20 members continue to affirm their commitment to the principles set forth at the 2009 Summit, differing “cultures, legal and political traditions, and financial systems” have produced challenges in actually harmonizing new regulatory frameworks.<sup>29</sup> These issues have been further complicated by the fact that each country is operating at its own pace in drafting and implementing regulations.<sup>30</sup> During 2012, the CFTC made a push to finalize its new swaps regulatory framework before the end of year in accordance with the deadline set at the 2009 G20 Summit. While some provisions went into effect before the planned deadline,<sup>31</sup> considerable debate emerged regarding what form regulations should take and how far national regulators should reach beyond their borders to regulate foreign entities engaged in swaps activities.

On July 12, 2012, the CFTC published “Proposed Guidance on the Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act” (the “proposed guidance”).<sup>32</sup> The

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BLOOMBERG (Feb. 5, 2013), <http://www.bloomberg.com/news/2013-02-05/clearinghouses-should-divulge-more-risk-information-report-says.html>.

<sup>28</sup> *The Risk in Clearing Houses: All Clear?*, *supra* note 27.

<sup>29</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41216; *see also* Press Release, Joint Press Statement of Leaders on Operating Principles and Areas of Exploration in the Regulation of the Cross-Border OTC Derivatives Market, Release PR6439-12, Dec. 4, 2012, <http://www.cftc.gov/PressRoom/PressReleases/pr6439-12>.

<sup>30</sup> *See* Press Release PR6439-12, *supra* note 29.

<sup>31</sup> For example, the requirement to register with the CFTC went into force last year for the foreign operations of U.S. financial institutions like Goldman Sachs Inc. but an exemptive order issued by the agency has delayed the effective date of a number of other provisions dealing with non-U.S. institutions. *See* CFTC Approves Exemptive Order on Cross-Border Application of the Swaps Provisions of Dodd-Frank, Release PR6478-12, Dec. 21, 2012, <http://www.cftc.gov/PressRoom/PressReleases/pr6478-12>; *see also* Silla Brush, *Dodd-Frank Swap Rules Delayed Six Months for Overseas Trades*, BLOOMBERG (Dec. 22, 2012), <http://www.bloomberg.com/news/2012-12-21/dodd-frank-swaps-rules-delayed-six-months-for-overseas-trades.html>.

<sup>32</sup> *See generally* Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4.

proposed guidance was intended to remedy the uncertainty surrounding how non-U.S. entities would be regulated under the new framework.<sup>33</sup> However, the proposed guidance received considerable criticism, particularly from foreign regulators who believed that the CFTC's proposed approach was too far reaching and would interfere with the ability of foreign nations' to regulate entities domiciled within their own jurisdictions.<sup>34</sup> Market participants that anticipated being regulated under the new U.S. framework also expressed concern over the costs and impracticalities of compliance.<sup>35</sup>

Part of the proposed guidance suggested a measure referred to as "substituted compliance." Substituted compliance would exempt a non-U.S. swaps dealer,<sup>36</sup> or major swap participant ("MSP"),<sup>37</sup> from certain requirements mandated by the CFTC if

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<sup>33</sup> See generally *id.*

<sup>34</sup> See Comment for Proposed Rule 77 Fed. Reg. 41213, Jess Lee for Australian Securities and Investments Commission, Hong Kong Monetary Authority, Monetary Authority of Singapore, Reserve Bank of Australia, and Securities and Futures Commission, Hong Kong, Aug. 27, 2012, <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58444>; see also Comment for Proposed Rule 77 Fed. Reg. 41213, French Minister of Economy and Finance, Chairmen of the Autorité de Contrôle Prudentiel, and Chairman of the Autorité de Marchés Financiers, Aug. 7, 2012, <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58417&SearchText=>.

<sup>35</sup> See Comment for Proposed Rule 77 Fed. Reg. 41213, R. Martin Chavez for Goldman Sachs, Aug. 27 2012, <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58622&SearchText=>; see also Comment for Proposed Rule 77 Fed. Reg. 41213, Edward J. Rosen for Bank of America Merrill Lynch, Barclays Capital, BNP Paribas, Citi, Credit Agricole Corporate and Investment Bank, Credit Suisse Securities (USA), Deutsche Bank AG, HSBC, Morgan Stanley, Standard Chartered Bank, UBS AG, Wells Fargo & Company, Aug. 16, 2012, <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58396&SearchText=>.

<sup>36</sup> The Commodity Exchange Act [hereinafter "CEA"] defines a "swap dealer" as any person who (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps, provided however, in no event shall an insured depository institution be considered to be a swap dealer to the extent it offers to enter into a swap with a customer in connection with originating a loan with that customer. 7 U.S.C. § 1a(49)(A) (2008).

<sup>37</sup> The CEA defines a "major swap participant" as "any person who is not a swap dealer, and (i) maintains a substantial position in swaps for any of the major swap categories as determined by the Commission, excluding (I) positions held for hedging or mitigating commercial risk; and (II) positions maintained by any

the regulatory framework of that non-U.S. entity's home jurisdiction was deemed comparable to the U.S. scheme.<sup>38</sup> While foreign regulators agreed that those exemptions were appropriate, they questioned the limited manner in which the CFTC proposed to apply substituted compliance.<sup>39</sup> As initially proposed, substituted compliance would still subject many non-U.S. firms to the regulations of multiple jurisdictions and likely result in dual compliance obligations that could prove expensive or altogether impossible to satisfy because of conflicting requirements.<sup>40</sup>

After closing the comment period for the proposed guidance on August 27, 2012, the CFTC began finalizing its approach.<sup>41</sup> As many of the swaps provisions were set to enter into force on October 12, 2012, the CFTC initially issued a series of no action letters indicating that it would refrain from recommending enforcement actions against certain foreign entities through the end of 2012.<sup>42</sup> The agency followed up the October no action letters with an exemptive order issued on December 21, 2012, which allowed non-U.S. entities that registered with the CFTC as swap

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employee benefit plan (or any contract held by such a plan) as defined in paragraphs (3) and (32) of section 1002 of Title 29 for the primary purpose of hedging or mitigating any risk directly associated with the operation of the plan; (ii) whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (iii) (I) is a financial entity that is highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency; and (II) maintains a substantial position in outstanding swaps in any major swap category as determined by the Commission.” 7 U.S.C. § 1a (33)(A) (2008).

<sup>38</sup> Memorandum from Shearman & Sterling, LLP, Cross-Border Application of the Swaps Provisions of the Dodd-Frank Act, 5 (July 18, 2012), <http://www.shearman.com/Cross-Border-Application-of-the-Swaps-Provisions-of-the-Dodd-Frank-Act-07-18-2012/>.

<sup>39</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, Steven Maijor for the European Securities and Markets Authority (ESMA), Aug. 27, 2012, <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58451&SearchText=>.

<sup>40</sup> *Id.*

<sup>41</sup> U.S. Commodity Futures Trading Commission, *Comments for Proposed Rule 77 FR 41213*, <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1234>.

<sup>42</sup> CFTC's Division of Swap Dealer and Intermediary Oversight Issues No-Action Letter Regarding the Swaps Calculation by Certain Foreign Entities for Purposes of the Swap Dealer and Major Swap Participant Definitions, Release PR6390-12, Oct. 12, 2012, <http://www.cftc.gov/PressRoom/PressReleases/pr6390-12>.



dealers or MSPs to delay compliance with a number of the new regulatory requirements until July 12, 2013.<sup>43</sup> Based on remarks from Chairman Gensler, the exemptive order was issued, at least in part, so as to allow for greater consideration of how the CFTC will regulate overseas branches of U.S. entities and how it will apply substituted compliance.<sup>44</sup>

Faced with the expiration of the December 2012 exemptive order, the CFTC issued the final version of its interpretive guidance (the “final interpretive guidance”) on July 12, 2013.<sup>45</sup> The interpretive guidance addressed many of the concerns that critics expressed regarding the proposed guidance and reflects a last minute agreement regarding joint cooperation between the swaps regulators in the U.S. and the European Union.<sup>46</sup> However, the final interpretive guidance does not resolve all of the potential issues created by the new regulations. Rather, it states that it will address any such conflicts, if and when they arise.

Part I of this paper will outline the key provisions of the new swaps regulations and discuss the CFTC’s interpretive guidance with respect to the extraterritorial reach of these provisions in greater detail. Part II will argue that, although the CFTC chose the correct medium to provide insight into how it will enforce the swaps regulations, in order to better address the concerns of foreign regulators and market participants, and implement the most effective regulatory framework possible, the U.S. should work quickly with its foreign counterparts to develop an explicit and internationally harmonized policy regarding the use of substituted compliance. Part II will further argue that the U.S. should establish a presumption in favor of granting substituted compliance to entities registered with other G20 members who have committed and continue to maintain a commitment to the principles set forth at the 2009 G20 Summit.

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<sup>43</sup> CFTC Approves Exemptive Order on Cross-Border Application of the Swaps Provisions of Dodd-Frank, Release PR6478-12, Dec. 21, 2012, <http://www.cftc.gov/PressRoom/PressReleases/pr6478-12>.

<sup>44</sup> See Brush, *supra* note 31.

<sup>45</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap regulations; Rule, 78 Fed. Reg. 45292 (Jul. 26, 2013).

<sup>46</sup> Silla Brush & Jim Brunsten, *Cross-Border Swaps Deal to End U.S.-Europe Regulation Overlap*, BLOOMBERG (Jul. 22, 2013), <http://www.bloomberg.com/news/2013-07-11/cross-border-swaps-deal-to-end-u-s-eu-regulation-overlap.html>.

## I. THE NEW REGULATORY FRAMEWORK

A swap can be broadly defined as “an agreement between parties to exchange cash flows over a period of time.”<sup>47</sup> Swaps generally fit into the following five categories: commodity, credit, currency, equity, or interest rate.<sup>48</sup> Businesses began using swaps in the 1980s to manage risks related to fluctuating commodities prices, currency rates, and interest rates.<sup>49</sup> Swaps allowed participants to customize their risk management because the transacting parties set the terms of each swap transaction.<sup>50</sup> As a newer product that resided outside the scope of the 1930s era financial legislation, swaps were not subject to reporting requirements that provide greater transparency in other sectors of the financial industry.<sup>51</sup> Title VII of Dodd-Frank specifically addressed this regulatory gap with respect to swaps.<sup>52</sup> However, Title VII left a great deal of discretion to the CFTC and the Securities and Exchange Commission (“SEC”) to promulgate regulations that will determine exactly how swaps will be regulated.<sup>53</sup>

In conjunction with the implementation of the broader policies set forth in Dodd-Frank, the CFTC and the SEC have partnered to develop comprehensive regulations to oversee the swaps industry.<sup>54</sup> Congress provided the CFTC with authority over swaps that are based on securities indices or government securities, while the SEC was given the power to oversee security-based swaps, meaning those swaps that are based on a single security or a narrow index of securities.<sup>55</sup> This division gives the

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<sup>47</sup> *Procter & Gamble Co. v. Bankers Trust Co.*, 925 F. Supp. 1270, 1275 (S.D. Ohio 1996).

<sup>48</sup> Christopher T. Fowler, *The Swaps Push-Out Rule: An Impact Assessment*, 15 N.C. BANKING INST. 205, 207 (2011).

<sup>49</sup> Gensler, *supra* note 3.

<sup>50</sup> Michael Mackenzie & Gregory Meyer, *US Swaps Shake-Up Set to Boost Exchanges*, FIN. TIMES, (Nov. 2, 2012, 5:32 PM), <http://www.ft.com/intl/cms/s/0/cadeef74-2377-11e2-a46b-00144feabdc0.html?siteedition=intl&siteedition=intl#axzz2eJISViJ2>.

<sup>51</sup> See Gensler, *supra* note 3.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.*

<sup>54</sup> *Id.*

<sup>55</sup> Memorandum from Davis Polk & Wardwell, LLP, Summary of Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21,

CFTC authority over approximately ninety-five percent of the swaps market.<sup>56</sup> Therefore, this paper will primarily focus on Dodd-Frank's amendments to the Commodity Exchange Act and the actions taken by the CFTC, as these matters will have the greatest impact on the swaps industry.

*A. Amendments to the Commodity Exchange Act*

Section 731 of Dodd-Frank amended Section 4s of the Commodity Exchange Act (the "CEA").<sup>57</sup> Section 4s(a) prohibits any person from acting as a swap dealer or MSP unless registered with the CFTC.<sup>58</sup> Section 4s(b) requires swap dealers and MSPs to file a registration application with the CFTC in accordance with the rules promulgated by the CFTC.<sup>59</sup> Section 4s also authorizes the CFTC to promulgate rules relating to capital and margin, reporting and record keeping, daily trading records, business conduct standards, documentation standards, duties, designation of a chief compliance officer, and segregation of uncleared swaps.<sup>60</sup>

Furthermore, Section 4s(b)(6) makes it unlawful for a swap dealer or MSP to permit any person associated with a statutorily disqualified swap dealer or MSP to effect or be involved in effecting swaps on behalf of it if the swap dealer or MSP knew, or should have known, of the disqualification.<sup>61</sup> Sections 8(a)(2) and 8(a)(3) provide grounds pursuant to which the CFTC may reject registration, including felony convictions and securities laws violations.<sup>62</sup> In addition to the registration, clearing, and reporting requirements, amendments to the CEA also provide the CFTC with

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2010, 53 (July 21, 2010), <http://www.davispolk.com/dodd-frank/memoranda/derivatives/>.

<sup>56</sup> Alexandra Alper & Sarah N. Lynch, *Regulators Spare All but Biggest Swap Dealers*, REUTERS (Apr. 18, 2012, 6:53 PM), <http://www.reuters.com/article/2012/04/18/us-financial-regulation-swaps-idUSBRE83H0YE20120418>.

<sup>57</sup> Commodity Exchange Act, 7 U.S.C. § 4s (1982); *see also* Commodity Futures Trading Commission, Office of Public Affairs, "Fact Sheet: Final Regulations Regarding Registration of Swap Dealers and Major Swap Participants," [http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF\\_1\\_Registration/index.htm](http://www.cftc.gov/LawRegulation/DoddFrankAct/Rulemakings/DF_1_Registration/index.htm).

<sup>58</sup> Registration of Swap Dealers and Major Swap Participants, 77 Fed. Reg. 2613, 2614 (proposed Jan. 19, 2012) (to be codified at 77 C.F.R. pt. 1).

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* at 2613.

<sup>62</sup> *Id.* at 2614.

enhanced rulemaking and enforcement authority with respect to all registered entities and intermediaries subject to its oversight.<sup>63</sup>

*B. The Cross-Border Reach*

Section 722(d) of Dodd-Frank amends Section 2(i) of the CEA to specify the Act's jurisdictional reach. Section 2(i) now states that the Act:

[S]hall not apply to activities outside the United States unless those activities: (1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or (2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of this chapter that was enacted by [Dodd-Frank].<sup>64</sup>

Thus, Congress explicitly authorized the CFTC to use its discretion to regulate foreign swaps activity particularly where the activity has a "direct and significant connection" to the U.S. economy. This grant of broad authority is undoubtedly a product of the policy concern that threats posed by investment products like swaps are not confined to the activities of U.S. entities. It permits the CFTC to issue regulations with the goal of reducing systemic risks. The CFTC is, thereby, empowered to oversee the activities of entities that would otherwise have been outside the scope of its jurisdictional authority. Congress, undoubtedly, wanted to ensure that the new regulatory framework would cover an entity like AIG Financial Products whose swaps transactions were a major factor in the collapse of AIG despite the fact that the company operated out of London and conducted its trades through a French bank.<sup>65</sup> The latitude of Section 2(i) provides the CFTC with the tools to do

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<sup>63</sup> Press Release, Sec. and Exch. Comm'n, SEC Adopts Rule Defining Swaps-Related Terms for Regulating Derivatives (Apr. 18, 2012), *available at* <http://www.sec.gov/news/press/2012/2012-67.htm>.

<sup>64</sup> 7 U.S.C. §2(i) (2010).

<sup>65</sup> Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n., Commodities and Futures Comm'n, Statement of Support (June 29, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement062912>).

so.

While Congress generally granted the CFTC broad discretion regarding the regulation of foreign entities, and the transactions in which they engage, it did limit the agency in one respect. Section 752(a) of Dodd-Frank provides that U.S. regulators:

Shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps, security-based swaps, swap entities, and security-based swap entities and may agree to such information-sharing arrangements as may be deemed to be necessary or appropriate in the public interest or for the protection of investors, swap counterparties, and security-based swap counterparties.<sup>66</sup>

Through this provision, Congress directed the CFTC to work with its foreign counterparts in developing the new swaps regulations. Yet, the mandate only requires such coordination where it is “deemed to be necessary,” once again granting the CFTC discretion to determine whether acting unilaterally or coordinating with foreign regulators is in the best interest of the U.S. The CFTC has acknowledged that Dodd-Frank authorized it to regulate swaps beyond U.S. borders, but has also indicated that in doing so it “will be guided by consideration of international comity principles.”<sup>67</sup> In other words, the CFTC expressed sensitivity towards the interests of its foreign counterparts with respect to regulating entities domiciled outside of the U.S. In order to fulfill its statutory mandates, the CFTC must therefore strike a balance between reducing risks to the U.S. markets and deferring to foreign regulators within their own jurisdictions.

### *C. The Significance of a “U.S. Person”*

The proposed guidance stated that where a foreign swaps dealer engages in \$8 billion or more in swaps transactions with

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<sup>66</sup> See Dodd-Frank Act, §725(a) (2010); see also 15 U.S.C. §8325(a) (2010).

<sup>67</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41217–41218.

entities that are considered “U.S. persons,” it must register pursuant to the CFTC’s registration rules.<sup>68</sup> Accordingly, determining whether a foreign swaps dealer exceeds the \$8 billion *de minimis* threshold and, therefore, whether it must register with the CFTC and be subject to the regulatory requirements of the CEA turns on whether the counterparty to a given transaction is a “U.S. person.”<sup>69</sup> The final interpretive guidance further clarifies the definition but does not change the significance of the term “U.S. person” in this context.<sup>70</sup> As the European Commission put it, the “definition determines the territorial scope of the Dodd-Frank Act.”<sup>71</sup>

The final interpretive guidance indicates that the CFTC considers the term “U.S. person” to encompass, non-exclusively the following: (i) any natural person who is a resident of the U.S.; (ii) any estate of a decedent who was a resident of the U.S. at the time of death; (iii) any legal entity other than an entity described in (iv) or (v) that is organized or incorporated under the laws of a state or other jurisdiction in the U.S. or having its principal place of business in the U.S.; (iv) any pension plan for employees, officers or principals of a legal entity described in (iii), unless the pension plan is primarily for foreign employees of such entity; (v) any trust governed by the laws of a state or other jurisdiction in the U.S., if a court within the U.S. is able to exercise primary supervision over the administration of the trust; (vi) any investment fund or other collective investment vehicle that is not described in (iii) and that is majority-owned by one or more persons described in (i), (ii), (iii), (iv), or (v) (where “majority-owned” means beneficial ownership of more than fifty percent of the equity or voting interest in the vehicle) except any vehicle that is publicly offered only to non-U.S. persons and not offered to U.S. persons; (vii) any legal entity that is directly or indirectly majority-owned by one or more persons described in (i), (ii), (iii), (iv), or (v) and in which such person(s) bears unlimited responsibility for

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<sup>68</sup> *Id.* at 41218 (noting that when a person engages in a swap transaction above a “de minimis threshold,” that person is required to register as a swap dealer under the Commodity Exchange Act).

<sup>69</sup> *Id.*

<sup>70</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap regulations, *supra* note 45, at 45316.

<sup>71</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, Jonathan Faull for the European Commission, Aug. 24, 2012, <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58431&SearchText=>.

the obligations and liabilities of the legal entity; and (viii) any individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint accounts) is a person described in (i), (ii), (iii), (iv), (vi), or (vii).<sup>72</sup>

The proposed guidance had included within its definition of a U.S. person any foreign branch or agent of a U.S. person, excluding a foreign affiliate or subsidiary of a U.S. person.<sup>73</sup> This meant that, for example, an interest rate swap involving Euros between an EU based swaps dealer and a Citibank branch located in the EU could have been required to comply with CFTC regulations even though the entire transaction occurred in the EU and would have already been subject to the oversight of the European Securities and Markets Authority (the “ESMA”).<sup>74</sup> This raised the concern that any entity subject to swaps regulations involving multiple jurisdictions could be required to not only comply with duplicative reporting requirements but also create an untenable situation where those entities would be required to comply with the clearing mandates of both jurisdictions.<sup>75</sup> The result would be that, in the case of a transaction between a European entity and a U.S. entity, both EU and U.S. regulations could apply.<sup>76</sup> Accordingly, an EU regulation requiring the European entity to clear the transaction through a European clearinghouse is incompatible with a CEA requirement that the U.S. party clear the transaction through a U.S. clearinghouse unless the clearinghouse were dually registered in the EU and U.S.<sup>77</sup> Japan also intends to impose a requirement that certain transactions be cleared through a Japanese clearinghouse, which could conflict with U.S. clearing requirements.<sup>78</sup> Additionally,

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<sup>72</sup> Interpretive Guidance and Policy Statement, *supra* note 45, at 45316-17; *see also* Memorandum from Davis Polk & Wardwell, LLP, CFTC Finalizes Cross-Border Swaps Guidance and Establishes Compliance Schedule, 2 (Jul. 30, 2013), [http://www.davispolk.com/sites/default/files/07.30.13.CFTC\\_Cross\\_Border\\_0.pdf](http://www.davispolk.com/sites/default/files/07.30.13.CFTC_Cross_Border_0.pdf)

<sup>73</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41218.

<sup>74</sup> *See* Memorandum from Shearman & Sterling, LLP, *supra* note 38.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* (discussing the possibility of conflicts that may arise in a transaction between a U.S. person and a non-U.S. person).

<sup>77</sup> *Id.*

<sup>78</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, Chris Young for the International Swaps and Derivatives Association, Aug. 10, 2012,

reporting requirements could pose another unworkable conflict where, as is the case in France and Germany, the foreign entity's home jurisdiction has more restrictive bank secrecy laws that would prohibit entities from disclosing the kind of information requested by the CFTC.<sup>79</sup>

In the final interpretive guidance, the CFTC acknowledged this potential for conflict of laws issues by stating "The Commission is mindful of the challenges presented by such circumstances and continues to work on a bilateral and multilateral basis with foreign regulators to address these issues."<sup>80</sup> Despite this declaration, the CFTC provided no concrete answer as to how these conflicts will be resolved. The interpretive guidance merely states, "where a real conflicts of law exists the Commission strongly encourages regulators and registrants to consult directly with its staff" and that the Commission "may consider reasonable alternatives that allow the Commission to fulfill its mandate while respecting the regulatory interests of other jurisdiction."<sup>81</sup> Essentially, the CFTC skirted the issue and indicated that it would address conflicts when they arise instead of providing a bright line rule for registrants, meaning registered swaps dealers and MSPs, to follow when they are faced with conflicting mandates. This lack of clarity will create further confusion and make additional work for the CFTC and the entities it regulates because it offers no actual guidance; only a statement that the CFTC "may consider" establishing some sort of exception for so called "real" conflicts.<sup>82</sup>

*D. The Consequences of the Proposed Definition of a "U.S. Person"*

In addition to the practical concerns related to complying

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<http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58356&SearchText=> (mentioning that Japan plans to create its own G-20 requirements demanding the use of a Japanese clearinghouse, which may conflict with U.S. requirements).

<sup>79</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, French Minister of Economy and Finance, *supra* note 34, at 2; *see also* Comment for Proposed Rule 77 Fed Reg. 41213, Tobias Unkelbach for the Association of German Banks, (Aug. 27, 2012), <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58450&SearchText=>.

<sup>80</sup> Interpretive Guidance and Policy Statement, *supra* note 45, at 45345.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*



with the regulation of multiple jurisdictions, registration could also impose a heavy burden on foreign swaps dealers and MSPs given that registrants would be required to comply with certain “entity level” and “transaction level” requirements of the CEA unless the transaction fell within the scope of a designated exception.<sup>83</sup> “Entity level” requirements refer to the capital adequacy, risk management, chief compliance officer, and swap data reporting and record keeping requirements.<sup>84</sup> “Transaction level” requirements relate to margin, clearing, segregation of uncleared swaps, trade execution, swap trading relationship documentation, portfolio reconciliation and compression, real-time public reporting, trade confirmation, daily trading records, and external business conduct standards.<sup>85</sup>

The proposed guidance indicated that registered swap dealers would need to comply with all entity level requirements unless they were deemed to be regulated by a comparable foreign regulatory framework and consequently granted an exemption from the CFTC requirements through the mechanism of substituted compliance.<sup>86</sup> Non-U.S. swaps dealers would still have to comply with all transaction level requirements when they engaged in transactions with persons or entities operating or incorporated in the U.S. or their foreign branches and for all transactions with overseas affiliates that are guaranteed by a U.S. entity.<sup>87</sup> Swaps with U.S. persons or their overseas branches would also count toward the \$8 billion *de minimis* registration threshold.<sup>88</sup> Prior to the issuance of the finalized interpretive guidance in July 2013, foreign regulators noted that the potential for overlap, duplication, and conflict of laws would be maximized if the CFTC applied a broad definition of a “U.S. person” with limited opportunities for substituted compliance.<sup>89</sup> A greater number of transactions would

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<sup>83</sup> Memorandum from Davis Polk & Wardwell, LLP, CFTC Cross-Border Guidance and Exemptive Order Proposals, 2 (July 3, 2012) <http://www.davispolk.com/dodd-frank/memoranda/derivatives/>.

<sup>84</sup> Memorandum from Davis Polk & Wardwell, LLP, *supra* note 72.

<sup>85</sup> *Id.*

<sup>86</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41227.

<sup>87</sup> Memorandum from Shearman & Sterling, LLP, *supra* note 38.

<sup>88</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41219.

<sup>89</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, Jonathan Faull for the European Commission, *supra* note 71.

be counted in the \$8 billion threshold, thereby requiring more non-U.S. entities to register with the CFTC. Moreover, as the European Commissioner for Internal Market and Services, Michel Barnier argued such an expansive interpretation sends a message that “American rules would take primacy over those in Europe” and in other nations.<sup>90</sup> Mr. Barnier also asserted that the efforts of regulators around the world to reform the swaps industry “will be in vain if we fail to realise that a global market can be regulated only by national rules that work together, closing gaps and avoiding overlaps.”<sup>91</sup> Mr. Barnier’s remarks highlighted the inherent problem with the CFTC’s proposed guidance. U.S. regulators stated repeatedly that they are committed to coordinating with their foreign counterparts and emphasized that the systemic risk of swaps necessitates a unified solution. Nevertheless, the CFTC’s broad “U.S. person” definition and limited use of substituted compliance as set forth in the proposed guidance took a decidedly unilateral approach to regulating the swaps market.

#### *E. Substituted Compliance under the Proposed Guidance*

The proposed guidance indicated that a determination regarding the application of substituted compliance to a non-U.S. person would be made by the CFTC on a firm-by-firm basis - meaning each swaps entity would have to request that the exemption be applied to it - and the CFTC would have to analyze each case on an individual basis.<sup>92</sup> According to the proposed guidance, exemptions would not apply to transaction-level requirements where the non-U.S. firm was engaging in business with an entity considered to be a U.S. person.<sup>93</sup> One of the primary reasons that foreign regulators and market participants criticized the substituted compliance standard described in the proposed guidance was the firm-by-firm, rule-by-rule analysis for determining the comparability of a foreign jurisdiction’s

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<sup>90</sup> Michel Barnier, *The US Must Not Override EU Regulators*, FIN. TIMES (June 21, 2012, 8:28 PM), <http://www.ft.com/cms/s/0/46584d1e-baee-11e1-81e0-00144feabdc0.html#axzz281fMMmAL>.

<sup>91</sup> *Id.*

<sup>92</sup> Comment for Proposed Rule 77 FR 41213, Steven Maijoor for the European Securities and Markets Authority (ESMA), *supra* note 39, at 3.

<sup>93</sup> Memorandum from Shearman & Sterling, LLP, *supra* note 38, at 5.

regulations. The issues raised by many of the comments to the proposed guidance revealed a number of flaws with the CFTC's initial proposal regarding substituted compliance.

To emphasize how strongly they opposed the proposed guidance, the financial authorities from the EU, France, Japan, and the U.K. not only submitted comments to the proposed guidance in August 2012, but also reiterated their position on October 17, 2012, in a joint letter to Chairman Gensler. The letter stated "it is critical to avoid taking steps that risk a withdrawal from global financial markets into inevitably less-efficient regional or national markets."<sup>94</sup> The letter further urged the CFTC to partner with its foreign counterparts to "collectively adopt cross-border rules consistent with the principle that equivalence or substituted compliance with respect to partner jurisdictions . . . should be used as far as possible to avoid fragmentation of global markets."<sup>95</sup>

#### *F. The European Approach*

The European Market and Infrastructure Regulation ("EMIR") contains the European Union's post-financial crisis legal reforms with respect to swaps. Just as the CFTC has drafted rules related to Dodd-Frank, the ESMA clarified EMIR by developing technical standards that were published on September 27, 2012.<sup>96</sup> Article 13(2) of Regulation No. 648/2012 of the European Parliament and of the Council on OTC Derivatives, Counterparties and Trade Repositories specifically outlines the EU's version of substituted compliance. The provision states:

The Commission may adopt implementing acts declaring that the legal, supervisory and enforcement arrangements of a third country: (a)

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<sup>94</sup> Vladimir Guevarra, *EU, Japan Warn Against New US Swaps Rules*, WALL ST. J. (Oct. 18, 2012, 12:32 PM), <http://online.wsj.com/article/SB10000872396390444734804578064600691285288.html> (quoting directly from a letter to CFTC Chairman Gary Gensler that was signed by European Commission Internal Market Commissioner Michel Barnier, French Finance Minister Pierre Moscovici, U.K. Chancellor of the Exchequer George Osborne and Japanese Minister of State for Financial Services Ikko Nakatsuka).

<sup>95</sup> *Id.*

<sup>96</sup> *ESMA Defines Standards for Derivatives and CCPs*, EUR. SEC. AND MKTS. AUTH. (Sept. 9, 2012), <http://www.esma.europa.eu/news/ESMA-defines-standards-derivatives-and-CCPs>.

are equivalent to the requirements laid down in this Regulation under Articles 4, 9, 10, and 11; (b) ensure protection of professional secrecy that is equivalent to that set out in this Regulation; and (c) are being effectively applied and enforced in an equitable and non-distortive manner so as to ensure effective supervision and enforcement in that country.<sup>97</sup>

The clear distinction between the EU's version of substituted compliance and the one proposed by the CFTC in the proposed guidance is that the comparability analysis is done based on the nation's regulatory scheme as a whole, not through an examination of an individual firm and its activities. Thus, non-European regulated institutions would be allowed to transact swaps business on the European markets if the ESMA declares the regulatory structure from their home countries to be equivalent.<sup>98</sup> The clearing, reporting, and risk management requirements of EMIR will all be considered satisfied where at least one of the counterparties to the swap transaction is regulated by a third country with an equivalent regulatory framework.<sup>99</sup> By permitting equivalent regulations to satisfy transaction-level requirements in this manner, EMIR creates a more workable regime for non-EU entities and alleviates some of the burden on its own resources that would otherwise be needed to extend its authority extraterritorially.

Because EMIR is a regulation, it has direct effect on all EU member states.<sup>100</sup> This is in contrast to an EU directive which requires member states to implement specific requirements through domestic laws, likely resulting in inconsistent polices across the EU.<sup>101</sup> This uniformity throughout the EU is one of the arguments the ESMA relied upon in calling for the CFTC to apply substituted

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<sup>97</sup> Regulation 648/2012, art. 13, of the European Parliament and of the Council of July 4, 2012 on OTC Derivatives, Counterparties and Trade Repositories, 2012 O.J. (L 201) 24, 25.

<sup>98</sup> Memorandum from Shearman & Sterling, LLP, *supra* note 38.

<sup>99</sup> *Id.* at 6.

<sup>100</sup> Holman Fenwick Willan, *Introduction to the European Market Infrastructure Regulation*, REGULATORY BULLETIN APRIL 2011 (April 2011), <http://www.hfw.com/publications/bulletins/regulatory-bulletin-april-2011/regulatory-bulletin-april-2011-introduction-to-the-european-market-infrastructure-regulation>.

<sup>101</sup> *Id.*

compliance to all EU regulated swaps institutions.<sup>102</sup> Great Britain's Financial Services Authority, now known as the Financial Conduct Authority,<sup>103</sup> and the French Minister of Economy and Finance echoed the ESMA in arguing that an equivalence system like the one employed by EMIR would avoid unworkable regulatory overlaps - like those presented by conflicting U.S. disclosure requirements and European bank secrecy laws - while simultaneously providing effective oversight of the markets.<sup>104</sup> The ESMA even offered to aid the CFTC in determining the best manner to apply an EU-wide substituted compliance approach.<sup>105</sup> Additionally, EU Commissioner Michel Barnier argued "where the rules of another country are comparable and consistent with the objectives of U.S. law, it is reasonable to expect US authorities to rely on those rules and recognize activities regulated under them as compliance. We in the EU can do exactly the same."<sup>106</sup> Thus, the European Commission also demonstrated a willingness to closely partner with the U.S. to ensure that no transaction or entity involving EU or U.S. counterparties will go unregulated.<sup>107</sup>

### *G. The Evolution of Substituted Compliance*

The CFTC first backpedaled on the version of substituted compliance that it described in the proposed guidance in a December 4, 2012, joint press statement with several of its foreign counterparts in which it agreed that substituted compliance determinations "will not be undertaken on a firm by firm basis but rather will focus on the applicable regime in a jurisdiction and will entail a review of laws, rules, supervision and enforcement."<sup>108</sup> Leading up to the issuance of the final interpretive guidance, the

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<sup>102</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, Steven Maijoor for the European Securities and Markets Authority (ESMA), *supra* note 39.

<sup>103</sup> FINANCIAL SERVICES AUTHORITY, *Journey to the Financial Conduct Authority*, [http://www.fsa.gov.uk/about/what/reg\\_reform/fca](http://www.fsa.gov.uk/about/what/reg_reform/fca).

<sup>104</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, French Minister of Economy and Finance, *supra* note 34; *see also* Comment for Proposed Rule 77 Fed. Reg. 41213, David Lawton for Financial Services Authority (UK), Aug. 24, 2012, available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58433&SearchText=>.

<sup>105</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, Steven Maijoor for the European Securities and Markets Authority (ESMA), *supra* note 39.

<sup>106</sup> Barnier, *supra* note 90.

<sup>107</sup> *Id.*

<sup>108</sup> Press Release, *supra* note 29.

CFTC worked extensively with its EU counterparts.<sup>109</sup> The collaboration between the CFTC and the European Union is most evident when considering how the approach to substituted compliance in the final interpretive guidance is more reflective of the EU's approach than what was originally outlined in the proposed guidance.

Pursuant to the final interpretive guidance, foreign regulators, an individual non-U.S. entity, a group of non-U.S. entities, a U.S. bank that is a swap dealer or MSP with respect to its foreign branches, or a trade association, or other group on behalf of similarly situated entities are all eligible to apply substituted compliance by requesting a comparability determination of their home jurisdiction.<sup>110</sup> Furthermore, "once a comparability determination is made for a jurisdiction, it will apply for all entities or transactions in that jurisdiction to the extent provided in the determination, as approved by the Commission."<sup>111</sup>

Although the final interpretive guidance alters certain controversial policies contained in the proposed guidance and attempts to address the concerns regarding extraterritorial overreaching, as Commissioner Scott O'Malia argued in his Dissenting Statement, the CFTC has taken a flawed approach to harmonizing its regulatory framework.<sup>112</sup> Instead of offering a clear expression on the cross-border application of the swaps provisions of Dodd-Frank that truly reflects cooperation with its foreign counterparts, the CFTC rushed to release the final interpretive guidance before it had worked out all of the details relating to substituted compliance.<sup>113</sup> The final interpretive guidance counters Commissioner O'Malia's assertion by noting that "no international consensus has emerged regarding the implementation of such reforms or the circumstances under which substituted compliance should be permitted."<sup>114</sup> Although this statement supports the CFTC's position to move forward absent an internationally harmonized framework, the of lack of clarity that still surrounds substituted compliance should have persuaded the

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<sup>109</sup> Brush, *supra* note 31.

<sup>110</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap regulations, *supra* note 45, at 45344.

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.* at 45373–45374.

<sup>114</sup> *Id.* at 45322.

CFTC to extend the December 2012 exemptive order to provide the necessary time for continued collaboration with foreign regulators and thus, the issuance of more complete guidance.

As it stands now, the CFTC stated that the comparability analysis required to determine if substituted compliance will apply to an entity “may be made on a requirement-by-requirement basis rather than on the basis of the foreign regime as a whole.”<sup>115</sup> The CFTC does indicate that “once a comparability determination is made for a jurisdiction, it will apply for all entities or transactions in that jurisdiction to the extent provided in the determination.”<sup>116</sup> It is quite possible that, in practice, the CFTC will grant substituted compliance to the key jurisdictions around the world in which swap dealers transact business. However, the final interpretive guidance provides no promises that this will be the case, and merely indicates that it will continue to work with foreign regulators and entities to resolve issues.<sup>117</sup> Additional time and greater collaboration prior to releasing the interpretive guidance would have allowed for a more concrete policy regarding the application of substituted compliance.

## II. STRIKING THE BALANCE

Financial juggernauts JPMorgan Chase & Co, Bank of America, Citigroup, HSBC, and Goldman Sachs collectively control about ninety-six percent of cash and derivatives trading.<sup>118</sup> The fact that four of these five entities are U.S. based companies does suggest that because the U.S. is such a major swaps player it should have an influential role in designing the global framework that will regulate the swaps market. However, taking the lead on this matter does not necessarily mean that the CFTC should act without recognizing the need for a coordinated effort with its foreign counterparts. Achieving the stated goal of safeguarding against systemic risks requires a more globally harmonized and concrete approach than the one articulated in the final interpretive guidance. The potential that non-U.S. swap dealers and MSPs will be faced with unworkable regulatory obligations if they are not

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<sup>115</sup> *Id.* at 45323.

<sup>116</sup> *Id.* at 45344.

<sup>117</sup> *Id.* at 45345.

<sup>118</sup> Alper & Lynch, *supra* note 56.

granted substituted compliance warrants hashing out the details of substituted compliance with foreign jurisdictions as quickly as possible now that the interpretive guidance has gone into effect.

*A. Interpretive Guidance vs. Formal Rulemaking*

By issuing a proposed guidance prior to the final interpretive guidance, the CFTC provided a medium for interested parties to submit comments and recommendations to assist in its consideration of how to carry out its oversight of the swaps industry. Some have criticized the fact that the CFTC chose to issue guidance instead of a rule.<sup>119</sup> Interpretive guidance is meant to better explain the requirements already contained within the CEA. It is not intended to create any new rights or obligations.<sup>120</sup> Additionally, the final interpretive guidance on the cross-border reach of the swaps regulations is not binding on the agency.<sup>121</sup> It only serves as an indication of how the CFTC will likely apply the CEA in practice.<sup>122</sup>

There could be a number of reasons why the CFTC chose this route. First, interpretive guidance does not require compliance with the Administrative Procedure Act (the "APA").<sup>123</sup> This allows the agency to clarify industry concerns more quickly and avoid expending resources to meet procedural requirements.<sup>124</sup> Faced with a tight deadline for implementation, the CFTC may have considered it important to promptly respond to the confusion expressed by foreign entities and regulators. Dodd-Frank directed

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<sup>119</sup> See Jill Sommers, Commissioner, U.S. Commodities Futures Trading Comm'n, Statement of Concurrence: (1) Proposed Interpretive Guidance and Policy Statement Regarding Section 2(i) of the Commodity Exchange Act; and (2) Notice of Proposed Exemptive Order (June 29, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/sommersstatement062912>).

<sup>120</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41214.

<sup>121</sup> See WILLIAM F. FUNK ET AL., ADMINISTRATIVE PROCEDURE AND PRACTICE: PROBLEMS AND CASES 345 (4th ed. 2010) (noting that interpretive rules, although expositive of an existing law or statute, are neither binding upon those subject to the law or statute, or the issuing agency).

<sup>122</sup> See *Id.* at 345 (stating that the interpretive rules, while not binding and creative of no new duties, have legal significance).

<sup>123</sup> Sommers, *supra* note 119.

<sup>124</sup> See FUNK ET AL., *supra* note 121, at 345.



the CFTC to draft more than 50 rules.<sup>125</sup> This task has been characterized as “Herculean,” given the fact that the CFTC typically only issues three or four rules per year.<sup>126</sup> The CFTC may also want to see how the swaps market operates under the guidance and gauge the industry reaction to its intended policy without binding itself to any rules that may prove ineffective or impractical. Interpretive guidance allows an agency to more easily alter its position than a rule; an option the CFTC may wish to keep open in the coming years.<sup>127</sup> Because interpretive guidance is not subject to the procedural requirements of the APA, the agency was not obligated to conduct a cost-benefit analysis before issuing it.<sup>128</sup> It is somewhat troubling to the business community that the CFTC has provided for such a sweeping application of its authority without offering any indication of the cost of such an approach.<sup>129</sup>

Regardless of the CFTC’s motives for offering interpretive guidance instead of promulgating a binding rule, the final interpretive guidance is indicative of how the agency intends to enforce the CEA, at least at these early stages of the regulation of the swaps industry. Consequently, the July 2012 proposed guidance prompted a great deal of attention from the swaps industry domestically and abroad when it was issued and the request for comments was made.

*B. The Presumption Should Be in Favor of Granting Substituted Compliance to Entities Registered With Other G20 Members*

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<sup>125</sup> Scott D. O’Malia, Commissioner, U.S. Commodities Futures Trading Comm’n., Smart Regulatory Reform and the Perils of High-Frequency Regulation (May 31, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-14>).

<sup>126</sup> Christian Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction and Dodd-Frank: The Implications of US Global OTC Derivative Regulation*, SOCIAL SCIENCE RESEARCH NETWORK, 24 (Oct. 30, 2012), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2169401](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2169401).

<sup>127</sup> See FUNK ET AL., *supra* note 121, at 355 (noting that the non-binding nature of an interpretive rule allows its issuing agency to readjust its approach to the rule being explained).

<sup>128</sup> Sommers, *supra* note 119 (stating that the Commission, because of the nomenclature of the current proposal, is neither bound by the requirements of the Administrative Procedure Act, nor the Commodity Exchange Act to “conduct a cost-benefit analysis”).

<sup>129</sup> *Id.* (citing the “extraterritorial reach of the Dodd-Frank Act” and a possible alternative that may avoid costly or duplicative regulations).

The CFTC's limited resources, coupled with concerns over international comity indicate that the CFTC should establish a presumption in favor of applying substituted compliance to foreign swap entities that are registered in and regulated by other G20 members who continue to exhibit a commitment to the principles set forth at the 2009 Summit. The interpretive guidance states that through collaboration with the EU, the CFTC staff determined that the "EU has adopted risk mitigation rules that are essentially identical to certain provisions of the Commission's business conduct standards for swap dealers and MSPs."<sup>130</sup> Accordingly the CFTC "determined that where a swap/OTC derivative is subject to concurrent jurisdiction under U.S. and EU risk mitigation rules, compliance under EMIR will achieve compliance with the relevant Commission rules because they are essentially identical."<sup>131</sup>

The CFTC should use the same collaborative approach that it took with the EU to work with jurisdictions that exhibit a similar willingness to negotiate and also recognize the benefits of developing complementary regulatory oversight of the swaps industry. Each G20 member has expressed a commitment to shared goals with respect to the regulation of the OTC derivatives markets and, therefore, it is likely that the financial authorities in those nations are willing to work with the CFTC in the same manner as the EU.<sup>132</sup>

Establishing a presumption in favor of granting substituted compliance to entities that are registered with other G20 members would most effectively carry out the CFTC's mandates to "reduce risk, increase transparency, and promote market integrity"<sup>133</sup> and to "consult and coordinate with foreign regulatory authorities."<sup>134</sup> Moreover, such a presumption would result in foreign jurisdictions monitoring more swaps dealers, market participants, and swap transactions. This would lessen the CFTC's oversight burden with respect to non-U.S. entities, thereby, conserving scarce resources

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<sup>130</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap regulations; Rule, 78 Fed. Reg. 45292, 45353 (Jul. 26, 2013).

<sup>131</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap regulations; Rule, 78 Fed. Reg. 45292, 45353 (Jul. 26, 2013).

<sup>132</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41215.

<sup>133</sup> See Press Release, *supra* note 63.

<sup>134</sup> 15 U.S.C. § 8325 (2010).

and avoiding the waste and inefficiency of duplicative regulations without sacrificing investor protection or market integrity.

### C. *The CFTC's Limited Resources*

Because the CFTC chose to clarify how it would apply the CEA extraterritorially in the form of interpretive guidance, instead of a binding rule, the agency avoided compliance with the requirements of the APA.<sup>135</sup> This meant that the CFTC was not required to engage in a cost-benefit analysis of its approach.<sup>136</sup> Both the CFTC and the SEC have recently lost lawsuits brought by industry groups challenging the adequacy of the agencies' cost-benefit analyses.<sup>137</sup> This could suggest that the CFTC was hoping to avoid litigation related to a cost-benefit analysis by choosing the interpretive guidance route. However, former Commissioner Jill Sommers<sup>138</sup> suggested that the failure to conduct such an analysis could actually expose the CFTC to litigation.<sup>139</sup> In its comment to the proposed guidance, the International Swaps and Derivatives Association ("ISDA") argued that the proposed guidance was mischaracterized as interpretive guidance and could actually be deemed a proposed legislative rule.<sup>140</sup> As to the final interpretive guidance, Commissioner O'Malia argued in his dissent that the interpretive guidance "has a practical binding effect and should have been promulgated as a legislative rule under the APA"<sup>141</sup> This could be grounds for a legal challenge and the basis of a defense to enforcement actions brought by the CFTC. Regardless of the fact that the CFTC characterized the finalized guidance as interpretive guidance, a court could still hold that it is in fact a

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<sup>135</sup> Sommers, *supra* note 119.

<sup>136</sup> *Id.*

<sup>137</sup> Sarah Lynch, *U.S. Regulator Calls for Do-Over on Cross-Border Swaps Plan*, REUTERS (Nov. 13, 2012), <http://currents.westlawbusiness.com/Article.aspx?id=23cf58af-b633-440a-9938-522880080e8f&cid=&src=&sp=>.

<sup>138</sup> Commissioner Sommers announced her resignation from the CFTC on January 24, 2013 and officially resigned on July 8, 2013. *See* Press Release, Commissioner Jill Sommers Announces her Resignation, Release PR6502-13 (Jan. 24, 2013), <http://www.cftc.gov/PressRoom/PressReleases/pr6502-13>; *see also* <http://cftc.gov/About/Commissioners/FormerCommissioners/index.htm>.

<sup>139</sup> Sommers, *supra* note 119.

<sup>140</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, Chris Young for the International Swaps and Derivatives Association, *supra* note 78.

<sup>141</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap regulations; Rule, 78 Fed. Reg. 45292, 45373 (Jul. 26, 2013).

legislative rule and was, therefore, subject to the procedural requirements of the APA.<sup>142</sup>

In a speech following the issuance of the proposed guidance, Commissioner O'Malia also expressed concern over the fact that a failure to conduct a cost-benefit analysis prevented market participants from commenting on the analysis.<sup>143</sup> Consequently, those who commented on the proposed guidance were left to speculate on potential costs of compliance and were unable to offer concrete arguments regarding its financial impact. Perhaps most importantly though, it raises the unsettling possibility that the CFTC did not meaningfully consider the costs of its proposed guidance or the final interpretive guidance. ISDA echoed Commissioner O'Malia's view that a cost-benefit analysis should be conducted and also asserted that failure to do so "risks appearing arbitrary."<sup>144</sup> ISDA again alluded to further grounds upon which a party could challenge the legality of the CFTC's interpretive guidance as a court can set aside an agency action if it finds that action was applied arbitrarily.<sup>145</sup> The fact that ISDA raised multiple grounds upon which a lawsuit could be based in its comment to the proposed guidance that were not resolved by the final interpretive guidance suggests the CFTC should anticipate the possibility of potentially costly litigation.

In addition to any expenses related to defending its policies in court, the CFTC must also consider the cost of actually enforcing these regulations. In accordance with the interpretive guidance, the CFTC has tasked itself with overseeing at least some of the entity level and transaction level requirements of any swap transaction in which at least one of the parties is a U.S. person or a foreign branch of a U.S. swap dealer, with many these transactions not being eligible for substituted compliance.<sup>146</sup> Thus, the theoretical cost of enforcing the swaps regulations broadly to non-U.S. entities, even absent a thorough cost-benefit analysis, should strongly motivate the CFTC to rely more heavily on substituted

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<sup>142</sup> FUNK ET AL., *supra* note 121, at 339.

<sup>143</sup> O'Malia, *supra* note 125.

<sup>144</sup> Comment for Proposed Rule 77 FR 41213, Chris Young for the International Swaps and Derivatives Association, *supra* note 78.

<sup>145</sup> See 5 U.S.C. § 706(2)(A) (1966).

<sup>146</sup> Memorandum from Davis Polk & Wardwell, LLP, CFTC Finalizes Cross-Border Swaps Guidance and Establishes Compliance Schedule, Appendix A-B (Jul. 30, 2013), [http://www.davispolk.com/sites/default/files/07.30.13.CFTC\\_Cross\\_Border\\_0.pdf](http://www.davispolk.com/sites/default/files/07.30.13.CFTC_Cross_Border_0.pdf)

compliance and its foreign counterparts where appropriate. According to Commissioner O'Malia, "The [CFTC] does not have the resources to register and regulate all market participants and swaps activities."<sup>147</sup> CFTC Commissioner Mark Wetjen expressed a similar concern when he stated in a speech at the 2012 Annual North American Conference of the International Swaps and Derivatives Association on September 13, 2012, "given the Commission's limited resources, as well as its currently limited view of these markets, we should cast our net only as wide as necessary to protect the public."<sup>148</sup>

By relying on its foreign counterparts through a robust substituted compliance standard, the CFTC would alleviate some of the economic and non-economic costs of regulating a voluminous and international base without sacrificing the integrity of the market. Moreover, the CFTC's limited resources could prevent the agency from effectively monitoring the domestic entities it regulates and restrict its ability to enforce the law.<sup>149</sup> By allowing foreign regulators to oversee entities and transactions with less significant connections to the U.S., the CFTC could better focus its resources on those activities that truly threaten domestic market integrity. Therefore, it is in everyone's interest for the CFTC to act swiftly to coordinate with foreign regulators and complete comparative determinations as soon as possible to enable the application of substituted compliance to entities and transactions that have less significant ties to the U.S.

#### *D. Costs and Consequences for Market Participants*

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<sup>147</sup> O'Malia, Comm'r, U.S. Commodities and Futures Trading Comm'n, Statement of Concurrence: (1) Proposed Interpretive Guidance and Policy Statement Regarding Section 2(i) of the Commodity Exchange Act; and (2) Notice of Proposed Exemptive Order (June 29, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement062912>).

<sup>148</sup> Mark P. Wetjen, Commissioner, U.S. Commodities Futures Trading Comm'n., 2012 Annual North American Conference of the International Swaps and Derivatives Association ("ISDA") (Sept. 13, 2012) (transcript available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/opawetjen-1>).

<sup>149</sup> Commissioner O'Malia argued, "by relying on comparable foreign regulatory regimes to address the trading activities of foreign market participants, the [CFTC] could better allocate resources domestically in a more effective manner." O'Malia, *supra* note 125.

In addition to concerns that the CFTC does not have the resources to effectively apply the swaps provisions in the manner described in the interpretive guidance, the expected economic and non-economic costs for market participants are also an issue. Standard and Poor's analysts estimate that large swaps dealers will experience a decrease in annual revenue between \$4 billion and \$4.5 billion as a result of the new regulations.<sup>150</sup> The burden of falling within the scope of the U.S. swaps regulations could encourage market participants to seek out less restrictive jurisdictions within which to transact business. This conduct is known as regulatory arbitrage.<sup>151</sup> The fear that restrictive swaps regulation would lead to regulatory arbitrage has existed since early on in the process of developing the new policies.<sup>152</sup> Certain Asian markets may be appealing targets for such conduct as Asia did not experience the same leverage-related issues that wreaked havoc on the West. Therefore, Asian regulators may be less inclined to adopt restrictive policies.<sup>153</sup> However, Asia may not ultimately be that much more attractive than the U.S. and EU. Ashley Alder, chief executive of Hong Kong's Securities and Futures Commission, has urged Asian regulators to adopt restrictive regulatory reforms in line with the West. Mr. Alder asserted "it would be unbelievably stupid to try and grow the Asian financial system while ignoring the problems that arose in the west."<sup>154</sup> Mr. Alder further argued, "there is no advantage in lowering our standards in order to attract business. That kind of regulatory arbitrage always ends in tears."<sup>155</sup>

Because the CFTC has broad powers to regulate extraterritorially under Section 2(i) of the CEA as amended by Section 722 of Dodd-Frank, the CFTC could attempt to curb regulatory arbitrage by maximizing its reach abroad. This may have been one of the motivating factors behind the broad approach

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<sup>150</sup> Johnson, *supra* note 126.

<sup>151</sup> Jonathan R. Macey, *Regulatory Globalization as a Response to Regulatory Competition*, 52 EMORY L. J. 1353, 1362 (2003).

<sup>152</sup> Johnson, *supra* note 126.

<sup>153</sup> Paul J. Davies, *HK Warns Asia Over Financial Reforms*, FIN. TIMES, (Nov. 27, 2012, 5:13 AM), <https://advance.lexis.com/GoToContentView?requestid=e81288c8-6b38-fabb-7fc4-c138fb55a4dd&crd=1ba537b6-181e-9b3e-d0d6-79165378dc31>.

<sup>154</sup> Davies, *supra* note 129.

<sup>155</sup> *Id.*

taken in the proposed guidance.<sup>156</sup> However, former Treasury Secretary Timothy Geithner stated in a letter to Senator Harry Reid in 2009 that coordination with foreign regulators was needed to combat regulatory arbitrage.<sup>157</sup> Accordingly, a more effective way for the U.S. to prevent regulatory arbitrage is to work closely with its foreign counterparts to ensure that regulations are comparable.<sup>158</sup> Acting unilaterally motivates market participants to search for ways around the CFTC's oversight, whereas a collaborative approach involving many jurisdictions makes evading regulatory requirements much more challenging because it reduces the number of less restrictive jurisdictions. That the final interpretive guidance describes a potentially more extensive application of substituted compliance suggests that the CFTC has heeded the advice of the comments it received to the proposed guidance and is working more collaboratively with foreign regulators. However, uncertainty still surrounds substituted compliance because the final interpretive guidance indicates that the use of substituted compliance requires an eligible party to make a request for the CFTC to conduct a comparative determination that could deny the application of substituted compliance entirely or apply only to certain requirements. Accordingly, it remains to be seen if regulatory arbitrage will become a significant issue as the swaps industry evolves under the new regulations.

In addition to potentially promoting regulatory arbitrage, a restrictive application of substituted compliance could also harm U.S. swaps dealers by making them less attractive counterparties to foreign entities.<sup>159</sup> Critics of the proposed guidance have argued that the burden of U.S. regulations could cause foreign market participants to avoid doing business in the U.S. or engaging in transactions with U.S. swaps dealers.<sup>160</sup> Asian banks have apparently already begun limiting their derivatives transactions with U.S. counterparties as a result of regulatory concerns.<sup>161</sup> Brazil's Securities and Exchange Commission has also indicated that Brazilian institutions could be discouraged from engaging in

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<sup>156</sup> Johnson, *supra* note 126.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*

<sup>159</sup> Guevarra, *supra* note 94.

<sup>160</sup> Stephen Foley, *EU and Japan warn US on Swaps*, FIN. TIMES (October 18, 2012, 7:13 PM), <http://www.ft.com/intl/cms/s/0/e88f017c-193f-11e2-af4e-00144feabdc0.html#axzz2hB1vmf2V>.

<sup>161</sup> *Id.*

swaps transactions with U.S. firms.<sup>162</sup> A widespread refusal to deal could substantially harm U.S. entities due to the frequency with which they enter into transactions with non-U.S. entities. Given that swaps provide important liquidity and risk management for U.S. entities, eliminating their ability to transact with non-U.S. entities could hurt the U.S. economy.<sup>163</sup> Additionally, some U.S. swaps dealers are major liquidity providers in certain emerging markets.<sup>164</sup> Such conduct may be curbed if U.S. swaps dealers are made less attractive counterparties because of U.S. regulations.<sup>165</sup> This could do financial harm to both U.S. swaps dealers and emerging markets, which would otherwise provide attractive investment opportunities for U.S. firms. The anticipated effect of the new regulations has reportedly already threatened Singapore's OTC swaps trading as market participants look for alternative investment options to avoid falling within the CEA's registration requirement.<sup>166</sup>

While it is important that the CFTC take into consideration concerns over the ability of U.S. firms to remain competitive in the swaps market in the face of the new regulatory framework, there is a limit to how far the agency should go in its application of substituted compliance. In its comment to the proposed guidance, Goldman Sachs urged the CFTC to make U.S. swap dealers "eligible for substituted compliance for transaction-level requirements to the same extent as non-U.S. swap dealers and non-U.S. branches of U.S. swap dealers."<sup>167</sup> This suggestion misses the point of substituted compliance, which is intended to combat potential conflicts of law, prevent swap dealers and MSPs from complying with duplicative requirements of multiple jurisdictions,

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<sup>162</sup> Guevarra, *supra* note 94.

<sup>163</sup> *Id.*

<sup>164</sup> Comment for Proposed Rule, Jess Lee, *supra* note 34.

<sup>165</sup> *Id.*

<sup>166</sup> Singapore serves as a key location for trading energy swaps. The trading is done OTC using specialized brokers. However, because entities are concerned with exceeding the U.S.'s \$8 billion threshold, they have turned away from swaps and are instead trading in products such as futures to meet their needs. Because the specialized swaps brokers are generally not registered with the Monetary Authority of Singapore to deal in the products their clients are now looking to trade, this niche industry in Singapore is now at risk of eventual extinction. See Jeremy Grant, *Singapore OTC Trades Hit by Turmoil*, FIN. TIMES, Nov. 2, 2012, at 20.

<sup>167</sup> Comment for Proposed Rule 77 Fed. Reg. 41213, R. Martin Chavez for Goldman Sachs, *supra* note 35.



and conform to international comity concerns. Where a market participant is unequivocally a “U.S. person,” as is the case with Goldman Sachs, there is no doubt that U.S. regulators have a compelling interest in regulating its conduct in the swaps market. Although Goldman Sachs may be correct in asserting that a failure to apply substituted compliance to U.S. entities will put such entities at a competitive disadvantage, the same could be true for foreign counterparties who are complying with their respective jurisdiction’s regulations.

#### *E. International Comity*

The CFTC has explicitly stated that in interpreting and applying its authority it will be mindful of the principles of international comity.<sup>168</sup> Commissioner Wetjen has argued that “as an initial matter, the law is clear that principles of international comity, and a healthy respect for the sovereign authority of other nations, are an integral part of determining the proper extra-territorial application of federal statutes.”<sup>169</sup> The doctrine of international comity provides that a court, using its own discretion, will defer to foreign laws and dismiss a case brought under U.S. law where the interests of the foreign nation involved outweigh domestic concerns.<sup>170</sup> This underlying principle translates into the regulatory context as well. Where a foreign interest in regulating a swap dealer, MSP, or swap transaction is stronger than the U.S. interest – as may be the case with the earlier example of a swap transaction between an EU entity and an EU based Citibank branch – U.S. regulators should defer to their European counterparts and allow the ESMA to oversee the transaction.

The Supreme Court has held that Congress must manifest an intent for a statute to apply extraterritorially in order for it to be applicable.<sup>171</sup> Section 2(i) of the CEA demonstrates that Congress did expressly intend for the CEA to apply extraterritorially in circumstances where the foreign conduct has “a direct and

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<sup>168</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41217–18.

<sup>169</sup> Wetjen, *supra* note 148.

<sup>170</sup> Thomas R. Sutcliffe, *The Nile Reconstituted: Executive Statements, International Human Rights Litigation, and the Political Question Doctrine*, 89 B.U. L. REV. 295, 324 (2009).

<sup>171</sup> *Morrison v. Nat’l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2885 (2010).

significant connection with activities in, or effect on, commerce of the United States.”<sup>172</sup> This same provision also gives the CFTC the power to promulgate cross-border regulations where it deems it “necessary or appropriate to prevent the evasion of” the CEA.<sup>173</sup> At the same time, Section 752(a) of Dodd-Frank tempers these grants of authority by instructing the CFTC to “consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards.”<sup>174</sup> These mandates require the CFTC to balance the interests of the U.S. in protecting its own markets with those of foreign regulators where international coordination would provide for more effective regulation. To apply the principles of international comity to this balance, the CFTC must weigh the foreign interest at stake and determine if deference to that foreign regulatory body is appropriate. The CFTC has asserted that the term “U.S. person” can assist in determining the weight of the U.S. interest,” meaning that, when the entity would be considered a “U.S. person,” the U.S. interest would outweigh the foreign interest.<sup>175</sup> However, an unnecessarily expansive definition of a U.S. person renders this argument less persuasive.

As the First Circuit stated in *United States v. Nippon Paper Industries Co.*, “comity is more an aspiration than a fixed rule.”<sup>176</sup> Thus, the CFTC is not bound by the doctrine of international comity beyond what is mandated by the CEA in terms of consulting and coordinating with its foreign counterparts.<sup>177</sup> Nevertheless, what makes international comity important in the context of regulating swaps is its relevance to maintaining strong relationships with foreign regulators. The critical reaction of so many foreign regulators to the proposed guidance is indicative of their expectation that the U.S. would respect their authority especially given the shared goal of ensuring market integrity and avoiding future financial crises. Adherence to the principles of international comity allows the CFTC to demonstrate this respect and maintain its partnerships abroad through deference to foreign

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<sup>172</sup> 7 U.S.C. § 2(i) (2010).

<sup>173</sup> *See id.*

<sup>174</sup> 15 U.S.C. § 8325 (2010).

<sup>175</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, 41218.

<sup>176</sup> *United States v. Nippon Paper Industries Co.* 109 F.3d 1, 8 (1st Cir. 1997).

<sup>177</sup> Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange, *supra* note 4, at 41218.

regulators within their own jurisdictions and where their interests are strongest.

#### CONCLUSION

The approach to substituted compliance set forth in the final interpretive guidance is a significant improvement over what was issued in the proposed guidance. However, the non-binding nature of interpretive guidance coupled with the uncertainty still present in the CFTC's outline of substituted compliance creates "statutorily weak guidance, with all its no-action riders and exemptions, with only the promise of further negotiation with our foreign counterparts."<sup>178</sup> These existing ambiguities should be corrected through ongoing negotiations with foreign regulators as soon as possible to avoid burdening the markets with duplicative and conflicting rules. Furthermore, in the interest of preserving resources and respecting the sovereignty of other nations, the CFTC should establish a presumption that G20 members have comparable regulatory frameworks.

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<sup>178</sup> Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap regulations, *supra* note 45, at 45373.