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Statement No. 340

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Statement of the Shadow Financial Regulatory Committee on

**The Dangers of Substituting Foreign Compliance for US
Supervision of Financial Derivatives Activity**

May 13, 2013

With the intention of enhancing financial stability, Title VII of the 2010 Dodd-Frank Act (DFA) seeks to set up a framework in which most standardized over-the-counter (OTC) derivatives will be cleared through registered central clearing parties (CCPs). Finding ways to assure a CCP's reliability is critical to its success. In the US and elsewhere, CCPs have found that enlisting government supervision of their trading procedures and financial condition can enhance confidence in their reliability. But at the same time, they can exploit opportunities for regulatory arbitrage and regulatory capture to lessen the costs of government oversight. Government supervision benefits a CCP because it helps it to access government credit support when and if its resources are overrun by adverse events.

As a response to the recent crisis, the DFA and G20 have created a new class of too-big-to-fail institutions. Constraining the risks these firms take must be an explicit goal of CFTC, SEC, and foreign rulemaking. On the other hand, finding ways to curtail the extent to which emerging rules actually constrain private firms' pursuit of profits is the goal of lobbying and other avoidance activities. Within and across borders, regulatory competition and the ability to persuade elected politicians to pressure regulators on their behalf helps the industry to bend the rules in their direction.

Regulation begets more regulation. Because the costs and benefits of expanding the geographic footprint of established CCPs and trading platforms derive mostly from regulatory differences, the Shadow Financial Regulatory Committee believes that US and foreign regulators must develop policies for directly or indirectly supervising platforms located in other countries. During the last year, the Chicago Mercantile Exchange (CME) has made it possible for its clients to

book a few of its foreign-exchange and interest-rate contracts with a London affiliate. Similarly, the IntercontinentalExchange (ICE) could easily register a US swaps CCP to book a selection of contracts currently trading in London.

Swaps regulators want markets to exhibit stability and liquidity. US derivatives rules proposed by the CFTC are perceived to stress stability more than those of other countries. British and other foreign regulators have expressed concern that applying US registration, capital, and collateral requirements to foreign branches, affiliates, or subsidiaries of US institutions may affect other regulators' freedom to tailor rules for foreign and domestic firms operating within their own jurisdictions. As a result, foreign regulators are trying to persuade the SEC and CFTC to write into their final rules a framework of "substituted compliance." Substituted compliance is a two-way street. It means that foreign affiliates of any firm would be regulated by the country in which they are domiciled as long as the country enforces rules "analogous" (i.e., similar) to those of the home country. Because "analogous" is less stringent than "congruent," the Shadow Financial Regulatory Committee fears that this word may be defined in a way that opens a back-door path for foreign affiliates of US firms to escape some desirable effects of US rules.

Why do definitions and tests entailed in substituted compliance raise this danger? During the 2008-2009 financial crisis, the Fed provided a surprisingly large amount of support to foreign financial firms and markets. For example, in the interests of financial stability, Fed officials decided to make whole each and every foreign and domestic counterparty in the deeply insolvent American International Group's huge book of credit default swaps. The risk is that some foreign regulators will substitute for US standards particular rules or enforcement procedures that would let CCPs in their jurisdiction book deep downside risks that they cannot fully finance. The CFTC and SEC must anticipate this possibility and take steps to limit the extent to which US taxpayers can be forced to fill in the gap.

The crucial issues are: (1) how to determine when one set of rules is and is not analogous to those of the US and (2) how to verify the adequacy of the enforcement of analogous rules on a continuing basis. The second issue has yet to be addressed, and the first issue has emerged as a point of contention between the CFTC and SEC. In June 2012, the CFTC proposed to classify for regulatory purposes the overseas arms of US banking organizations as "US persons." Adopting this definition would expand the territorial reach of CFTC scrutiny so that swaps that US persons execute abroad would not be regulated any differently from those they execute in the US.

This interpretation has the advantage of keeping responsibility for growth in the US safety net in US hands, but it is greatly disliked by foreign regulators and their opposition has received support from the SEC. In an April 19th letter, officials from Germany, France, the UK, Japan and the European Commission recommended that substituted compliance be made available to all market participants for all transactions-level and entity-level rules. Less than two weeks later, the SEC formally proposed to permit overseas-based firms to adhere to their foreign jurisdiction's rules in deals with US firms so long as the foreign rules are "broadly

comparable” to US requirements. Since the antonym for “broad” is “narrow,” introducing this modifier widens opportunities for cross-border regulatory arbitrage.

The Shadow Financial Regulatory Committee believes that this controversy is misfocused. In its Statement No. 321 (December 5, 2011), the Committee argued that cross-country regulatory arrangements such as Basel III should make regulators in different countries accountable to one another for breaching standards of best regulatory practices. What is needed is an honest and continuing conversation about best practices. The volume of regulatory arbitrage observed in recent years underscores the importance of making regulators in individual countries explain candidly why they have introduced country-specific standards or unusual practices into their regulatory frameworks.

Rather than jousting for jurisdiction, it would be far better for swaps regulators in different venues to focus on criticizing and defending deviations from best practices that have developed in individual countries. The Shadow Financial Regulatory Committee proposes establishing a global regulatory forum in which swaps regulators would address two tasks. As in the Basel process, the first task would be to thrash out and articulate basic “principles” for swaps regulation and supervision that delegates from participating countries believe would promote liquidity and global financial stability. An example might be to require that every country monitor the margining, collateral, and capital adequacy of CCPs that operate within its borders. But the Cross-Country Committee (CCC) would recognize the right of individual-country regulators to make and enforce a network of specific rules intended to apply the CCC's core principles to domestic and foreign CCPs that operate within its borders. This arrangement would allow country-specific actions to adapt global principles to the ever-changing financial environment, but hopefully in coordinated ways.

If CCPs and swaps regulators were to take this approach to coordination, they could define and apply regulatory principles more effectively. Members of the regulatory community would be encouraged to speak openly and honestly about the challenges faced in crafting meaningful rules, while maintaining the right to adjust their standards to local political and economic circumstances.

Rule-making is an evolutionary and potentially perverse process. The second task of the CCC would be to coordinate individual-country rule-making and enforcement. For countries that join its cross-country regulatory system, the CCC should set up and house a cross-country monitoring and compliance bureau charged with identifying, assessing, and explicitly approving or disapproving the manner in which conflicts in implementing the body's core principles are and are not successfully resolved. This second arm would act as a global overseer of national regulators. Its purpose would be to assess the extent of any misalignment of regulatory incentives and to track and publicize deviations from established principles where they are observed.

