

1-1-2015

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Recommended Citation

Lindenfeld, Jonathan (2015) "The CFTC's Substituted Compliance Approach: An Attempt to Bring About Global Harmony and Stability in the Derivatives Market," *Journal of International Business and Law*: Vol. 14: Iss. 1, Article 6.
Available at: <http://scholarlycommons.law.hofstra.edu/jibl/vol14/iss1/6>

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THE CFTC'S SUBSTITUTED COMPLIANCE APPROACH: AN ATTEMPT TO BRING ABOUT GLOBAL HARMONY AND STABILITY IN THE DERIVATIVES MARKET

Jonathan Lindenfeld*

*In the derivatives market "risk knows no geographic borders."*¹

I. INTRODUCTION

G20 leaders met in Pittsburgh following the financial crisis of 2008 to address and prevent the regulatory mishaps and defects of the derivatives market, which many commentators believe sent global markets into a recession.² The G20 set out two foundational principles for the market that they wished to achieve by 2012: a more transparent market and a more stable financial system.³ In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to implement these objectives.⁴

This Note argues that substituted compliance regarding the extraterritorial jurisdiction of cross-border swaps regulation is the most effective approach for the Commodity Futures Trading Commission ("CFTC") to achieve the goals set out by the G20. Substituted compliance is a concept whereby the CFTC may exempt foreign entities from certain compliance regulations if it deems a host country's regulations are comparable and comprehensive as those of the CFTC.⁵ As set forth in Part IV of this Note, substituted compliance will allow the CFTC to use its limited resources⁶ in the most efficient manner possible, while still fulfilling its mandate to regulate the swap market under Title VII of Dodd-Frank.⁷

Part II of this Note explains the importance of the financial crisis of 2008, and how it ultimately had a lasting impact on the regulatory regimes of financial markets. The

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¹ Gary Gensler, Chairman, Commodity Futures Trading Comm'n, Keynote Address at the Sandler O'Neill Conference: Cross-Border Application of Swaps Market Reform (June 6, 2013), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-141> [hereinafter Gensler Keynote Address on Cross-Border Application].

² See generally Leaders' Statement, Sept. 24-25, 2009, *The Pittsburgh Summit*, ¶ 1, *available at* http://www.treasury.gov/resource-center/international/g7g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf [hereinafter *The Pittsburgh Summit*].

³ *Id.* ¶ 26.

⁴ Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), *available at* <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf> [hereinafter Dodd-Frank Act].

⁵ See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292, 45342 (proposed July 26, 2013), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-07-26/pdf/2013-17958.pdf> [hereinafter Final Guidance].

⁶ See *infra* Part IV.A.

⁷ Dodd-Frank Act §§ 701-74.

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financial crisis of 2008 revealed the serious threat that the derivative market may pose to the financial stability of global markets.⁸

Part III of this Note examines the extraterritorial reach of Title VII of Dodd-Frank, and the CFTC's interpretation of its mandate. The swap market by its very nature is a global market.⁹ Consequently, the CFTC will regulate certain cross-border swap activities conducted outside the United States, which ultimately may have an effect back home.¹⁰ Cross-border swaps are derivative trades conducted between a U.S. person and a non-U.S. person.¹¹ The effectiveness of Dodd-Frank could all be essentially nullified if U.S. persons are able to evade the requirements of the CFTC or other cross-border transaction regulations.¹²

Part V of this Note conducts an analysis of the benefits of substituted compliance, and sets forth the reasons as to why substituted compliance is the most appropriate course of action. If the CFTC were to not allow for substituted compliance, regulatory arbitrage could result in lead to a race to the bottom for investors who may be incentivized to transact in the jurisdiction with the most favorable regulators.¹³

Part VI of this Note makes five strategic recommendations that would increase regulatory efficiencies and assist both businesses and the CFTC. These critical improvements include: (1) increased collaboration efforts among foreign regulators, (2) greater acceptance of differences in regulatory frameworks among regulators, (3) limiting the amount of regulatory uncertainty within the market, (4) addressing the risk culture in many of the market participants, and, most importantly, (5) substituted compliance determinations must be as transparent as possible.

Part VII concludes this Note by arguing that the CFTC's approach to substituted compliance provides a sufficiently flexible framework, allowing the CFTC to adapt and evolve along with the dynamic nature of the derivatives market.

⁸ See *infra* Part II.A. "Derivatives are financial contracts whose prices are determined by, or 'derived' from, the value of some underlying asset, rate, index, or event...they are instruments for hedging business risk or for speculating on changes in prices, interest rates, and the like." THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 45-46 (2011), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf [hereinafter FCIC Report].

⁹ See *infra* Part III.A; see also COMMODITY FUTURES TRADING COMM'N & SEC, JOINT REPORT ON INTERNATIONAL SWAP REGULATION 115 (2012), available at <http://www.sec.gov/news/studies/2012/sec-cfte-intlswapreg.pdf>. "According to an ISDA survey, the fourteen most active international derivatives dealers" accounted for 82 percent of the market. Of these fourteen dealers, they "are based in five different countries, and only six are based in the United States." *Id.*

¹⁰ Commodity Exchange Act, 7 U.S.C. § 2(i).

¹¹ See David Felsenthal & Lily Chu, *Regulation of Cross-Border Swaps*, 3 HARV. BUS. L. REV. ONLINE 142, 143 (2013), available at http://www.hblr.org/wp-content/uploads/2013/04/Felsenthal_Cross-Border.pdf.

¹² See Gensler Keynote Address on Cross-Border Application, *supra* note 1.

¹³ See Annelise Riles, *Managing Regulatory Arbitrage: A Conflict of Laws Approach*, 47 CORNELL INT'L L.J., no. 1, 2014, at 63, 73.

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II. BACKGROUND

A. History of the 2008 Financial Crisis: How We Got Here

In December 2000, President Clinton signed the Commodities Futures Modernization Act ("CFMA"),¹⁴ which deregulated the derivatives market by removing oversight by the CFTC or SEC.¹⁵ After the enactment of CFMA, the derivatives market exploded sevenfold, reaching a notional amount of \$672.6 trillion by 2008.¹⁶ Former SEC Chairman Christopher Cox described the pre-crisis swaps market as one that was "completely lacking in transparency, and virtually unregulated."¹⁷ As a result of the financial crisis of 2008, U.S. and foreign regulators have been promulgating new regulations for the derivative market in order to prevent similar crises in the future.¹⁸ Prior to the implementation of Dodd-Frank, the swaps market was largely unregulated in the U.S. and abroad.¹⁹

Since the 2008 financial crisis it has become generally accepted that the derivative market significantly contributed to the crisis.²⁰ Prior to the crisis many large financial institutions were using credit default swaps ("CDS") as a means of "insuring" against some of their overly risky subprime business practices.²¹ However, when many of these loans went

¹⁴ Commodities Futures Modernization Act, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

¹⁵ FCIC Report, *supra* note 8, at 48.

¹⁶ *Id.*

¹⁷ Christopher Cox, Chairman, SEC, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008), *available at* <http://www.sec.gov/news/speech/2008/spch100808cc.htm>. Christopher Cox was Chairman of the Securities and Exchange Commission ("SEC") during the financial crisis under the Bush administration. Furthermore, Cox characterized the lack of oversight as a "regulatory black hole" that presented one of the most significant issues during the crisis, which required immediate legislative action. *Id.*; see Jeremy Gogel, "Shifting Risk to the Dumbest Guy in the Room" - *Derivatives Regulation After the Wall Street Reform and Consumer Protection Act*, 11 J. OF BUS. & SEC. L., no. 1, Fall 2010, at 1, 31.

¹⁸ See generally *The Pittsburgh Summit*, *supra* note 2.

¹⁹ Marcy Gordon, *Why Rift on Derivatives is Blocking US Budget Bill*, ABC NEWS, (Dec. 11, 2014, 2:08 PM), <http://abcnews.go.com/Business/print?id=27536340>. "Dodd-Frank established a regime to regulate the unregulated derivatives market, including regulation of interest rate swaps, non-spot foreign exchange transactions...currency swaps, physical commodity swaps, total return swaps, and credit default swaps." See Edward Greene & Ilona Potiha, *Issues in Extraterritorial Application of Dodd-Frank's Derivatives Rules: Update with Focus on OTC Derivatives and Clearing Requirements*, 8 CAPITAL MARKETS L. J., no. 4, 2013, at 338, 339, *available at* <http://cmlj.oxfordjournals.org/content/8/4/338.full.pdf>.

²⁰ See Nick Alexopoulos, *The Role of Derivatives in the Financial Crisis*, UMB NEWS (Jul. 6, 2010), <http://www.oia.umb.edu/communications/news/?ViewStatus=FullArticle&articleDetail=9855>. Two key supporters of CFMA in 2000, former SEC Chairman Arthur Levitt and former Federal Reserve Chairman Alan Greenspan, have acknowledged the damage that the deregulated credit default swap market contributed to the financial crisis. TESTIMONY OF MICHAEL GREENBERGER, THE ROLE OF DERIVATIVES IN THE FINANCIAL CRISIS, FIN. CRISIS INQUIRY COMM'N HEARING 12-13 (2010), *available at* http://www.michaelgreenberger.com/files/FCIC-Michael_Greenberger_Testimony.pdf [hereinafter GREENBERGER TESTIMONY].

²¹ FCIC Report, *supra* note 8, at 50. Credit default swaps are OTC derivatives "which offered the seller a little potential upside at the relatively small risk of a potentially large downside. The purchaser of a CDS transferred to the seller the default risk of an underlying debt. The debt security could be any bond or loan obligation. The CDS buyer made periodic payments to the seller during the life of the swap. In return, the seller offered protection against default or specified 'credit events' such as a partial default. If a credit event such as a default occurred, the CDS seller would typically pay the buyer the face value of the debt." *Id.*

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bad, the CDS market brought about the mortgage crisis, which in turn created a credit crisis, and culminated in a financial crisis, requiring a huge bailout from U.S. taxpayers.²²

This cascade of events revealed one major problem with the lack of regulations for derivatives. The safeguards used for other similar business activities, such as the insurance industry, were not in place.²³ Insurance companies are required to have statutory reserves, which are overseen by state regulatory agencies, to ensure insolvency is avoided and that companies will be able to pay out on their policies.²⁴ However, there were no such reserve requirements placed on the derivatives that companies were selling.²⁵ For instance, prior to the near-collapse of AIG, the company accumulated a \$500 billion position in credit risk through the derivatives market, without being required to post a single dollar in reserves or make any other arrangement for unforeseen loss.²⁶ AIG underwrote nearly \$80 billion in CDS while it only had \$20 billion in its regulated insurance reserve funds.²⁷ By the end of 2007, the CDS market peaked worldwide at \$58.2 trillion.²⁸

In September 2009, G20 leaders gathered in Pittsburgh to address the risk that the derivatives market posed to global financial markets.²⁹ The leaders reached an understanding that, in order to make the derivatives market safer, they must lower risk and promote transparency in the derivatives market.³⁰ Consequently, Congress passed Dodd-Frank in 2010 to address the issues identified in G20 Pittsburgh Summit which resulted in the 2008 financial crisis.³¹

B. Global Nature of Swaps

Prior to the recent regulatory reforms following the 2008 financial crisis, the swaps market largely operated without regulatory oversight.³² Further, the 2008 financial crisis demonstrated that the swap market is a global market that is tightly interconnected.³³ This

²² See GREENBERGER TESTIMONY, *supra* note 20, at 11.

²³ FCIC Report, *supra* note 8, at 50.

²⁴ *Id.*

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*; see also Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 495 (2009).

²⁸ FCIC Report, *supra* note 8, at 50.

²⁹ *The Pittsburgh Summit*, *supra* note 2, ¶¶ 1, 3 (reiterating the risk the derivatives market posed to global financial markets).

³⁰ See *id.* ¶ 11. "All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end- 2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse." *Id.* ¶ 13.

³¹ Greene & Potiha, *supra* note 19, at 343 (stating that Title VII of Dodd-Frank repealed the Commodity Futures Modernization Act of 2000 and created a new regulatory structure for the derivatives market).

³² See Gordon, *supra* note 19.

³³ See Final Exemptive Order Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 858, 860 (Jan 7, 2013) (to be codified at 17 C.F.R. ch. I), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2013-01-07/pdf/2012-31736.pdf> [hereinafter Final Exemptive Order].

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interrelation amplifies the danger of systemic risk and contagion that derivatives pose to global markets are transmitted across national borders and can affect multiple jurisdictions. Taking advantage of the nature of the swap market, some of the largest and most powerful financial institutions created a complex web of legal entities and subsidiaries, spanning multiple countries and jurisdictions.³⁴ Therefore, international cooperation and coordination in derivatives regulations is critical.³⁵

The global character of such companies means the risk taken on by a foreign subsidiary can fall right back onto the parent company in the U.S. For example, when A.I.G. nearly collapsed in September 2008, it required a \$180 billion bailout from the U.S. taxpayers.³⁶ It was A.I.G.'s Financial Products unit, based in London and operating under a French banking license, that was largely responsible for its overly risky activity.³⁷ Another example of this risk is JPMorgan's London branch with the "London Whale" whose trades ultimately had a substantial effect on its U.S. bank and the market.³⁸

Former CFTC Chairman Gensler³⁹ noted, "when a run starts on any overseas affiliate or branch of a modern financial institution, risk comes crashing back to our shores."⁴⁰ "[I]t was financial institutions operating complicated swaps businesses in offshore entities that nearly toppled the U.S. economy" in the financial collapse of 2008.⁴¹ Of all the new regulations imposed on the derivatives markets, those involving cross-border swaps are the most contentious and critical for success, because half of big bank swaps involve overseas clients.⁴² If banks are able to evade regulations on cross-border swaps, the market will surely fail to achieve the transparency that the G20 desired and will once again become as opaque as it was prior to the crisis.

³⁴ See, e.g., Gensler Keynote Address on Cross-Border Application, *supra* note 1. Lehman Brothers had over 3,300 different legal entities at the time it went bankrupt. See *id.*

³⁵ See Final Exemptive Order, *supra* note 33, at 860.

³⁶ Steve Schaefer, *U.S. Wraps Up AIG Bailout With \$7.6B Stock Sale, Touts \$22.7B Return*, FORBES (Dec. 11, 2012, 10:25 AM), <http://www.forbes.com/sites/steveschaefer/2012/12/11/treasury-wraps-up-aig-bailout-with-7-6b-stock-sale-touts-22-7b-return/>.

³⁷ Gensler: *Regulations Struck 'Right Balance' on Rules* (Bloomberg TV video Dec. 30, 2013), available at <http://www.bloomberg.com/video/gensler-regulators-struck-right-balance-on-rules-GOaeFZkaTUmcMc0PMfxONw.html>; accord *Could A.I.G. Happen Again?*, NY TIMES (Dec. 23, 2012), http://www.nytimes.com/2012/12/24/opinion/could-aig-happen-again.html?_r=0.

³⁸ Patricia Hurtado, *The London Whale*, BLOOMBERG, (Oct. 21, 2014, 4:39 PM), <http://www.bloomberg.com/quicktake/the-london-whale/>; see Joe Coscarelli, *Who Is the London Whale? Meet JPMorgan's 'Humble' Trade Bruno Iksil*, N.Y. MAG. (May 11, 2012, 10:16 AM), <http://nymag.com/daily/intelligencer/2012/05/jpmorgan-london-whale-bruno-iksil-2-billion-loss.html>. Bruno Michel Iksil, now known as the "London Whale" was responsible for a \$6.2 billion loss and a \$100 million CFTC fine for J.P. Morgan. Gensler Keynote Address on Cross-border Application, *supra* note 1.

³⁹ Scott Patterson & Jamila Trindle, *Gensler to Step Down as CFTC Chairman*, CFTC.GOV (Oct. 3, 2013), <http://www.cftc.gov/PressRoom/InTheNews/ni0104-13>. After almost five of the most transforming years of the agency, Gary Gensler stepped down as Chairman and left the CFTC at the end of 2013. *Id.*

⁴⁰ Robert Schmidt & Silla Brush, *Banks Said to Seize 'Footnote 513' to Keep Swaps Private*, BLOOMBERG (Oct. 23, 2013, 12:01 AM), <http://www.bloomberg.com/news/2013-10-23/banks-said-to-seize-footnote-513-to-keep-swaps-private.html> (quoting Gensler Keynote Address on Cross-border Application, *supra* note 1).

⁴¹ See *id.*

⁴² See *id.*; Jim Brunsten, *EU Says Gensler Swaps Rule Clashes With Trans-Atlantic Pact*, BLOOMBERG (Nov. 21, 2013, 9:52 AM), <http://www.bloomberg.com/news/2013-11-21/eu-says-gensler-swaps-rule-clashes-with-trans-atlantic-pact.html>.

C. Dodd-Frank Title VII reforms

Title VII of Dodd-Frank provides the CFTC with the authority to regulate both domestic and foreign swap activities which affect the US.⁴³ Two key provisions of Dodd-Frank and the corresponding new regulations on swaps are, mandatory clearing and reporting obligations.⁴⁴ Since Dodd-Frank was passed, the CFTC has already adopted numerous reporting requirements, which require periodic and timely reporting by firms for a swap transaction and life-cycle information.⁴⁵ Beginning in late November 2013, the CFTC began to publish weekly swaps reports, in which the CFTC aggregates swap market data reported by registered market participants to registered Swap Data Repositories (“SDRs”).⁴⁶

The new mandatory clearing requirements for swaps marks one of the most significant reforms Dodd-Frank made to the swaps market.⁴⁷ Dodd-Frank section 723 added section 2(h)(1) to the Commodity Exchange Act (“CEA”),⁴⁸ which requires any person engaged in a swap to submit such swap to a registered derivatives clearing organization (“DCO”).⁴⁹ Former CFTC Chairman Gensler expressed the opinion that “central clearing lowers the risk of the highly interconnected financial system. It promotes competition in and broadens access to the market by eliminating the need for market participants to individually determine counterparty credit risk, as now clearinghouses stand between buyers and sellers.”⁵⁰ However, central clearing is a contentious issue.

A major criticism about central clearing is that it does not actually reduce risk, it simply aggregates it into a single location.⁵¹ By shifting some of the risk of counterparties to clearing houses it can create “too big to fail, on steroids.”⁵² When asked about central clearinghouses Chairman of the Federal Reserve Ben Bernanke quoted Mark Twain, “if you put all your eggs in one basket, you better watch that basket.”⁵³

⁴³ Dodd-Frank Act, Pub. L. No. 111-203, § 722, 124 Stat. 1376, 1672 (2010).

⁴⁴ Dodd-Frank Act §§ 723, 729, 766; *see also* Final Guidance, *supra* note 5, at 45,331-40.

⁴⁵ *See* Real-Time Public Reporting, 17 C.F.R. § 43.1 (2012); Swap Data Recordkeeping & Reporting, 17 C.F.R. § 45.2; *see also* Felsenthal & Chu, *supra* note 11. The language most commonly used in the regulations is “as soon as technologically practicable” when refereeing to the timing requirements. 17 C.F.R. § 43.1.

⁴⁶ *See generally* *Weekly Swaps Report*, U.S. COMMODITY FUTURES TRADING COMM’N, <http://www.cftc.gov/MarketReports/SwapsReports/index.htm> (last visited Dec. 18, 2014). The Weekly Swaps Reports are released every Wednesday at 3:30 PM. The reports are organized by Gross Notional Outstanding, Transaction Dollar Value, and Transaction Ticket Volume. The information reported in the weekly reports were previously unreported to regulators and generally not available to the public. *Id.*

⁴⁷ Press Release, Commodity Futures Trading Comm’n, CFTC Announces that Mandatory Clearing Begins Today (Mar. 11, 2013), *available at* <http://www.cftc.gov/PressRoom/PressReleases/pr6529-13>.

⁴⁸ Commodity Exchange Act, 7 U.S.C. §2(h)(1) (2012).

⁴⁹ Dodd-Frank Act, Pub. L. No. 111-203, § 723, 124 Stat. 1376, 1675 (2010).

⁵⁰ Press Release, Commodity Futures Trading Comm’n, CFTC Announces that Mandatory Clearing Begins Today (Mar. 11, 2013), *available at* <http://www.cftc.gov/PressRoom/PressReleases/pr6529-13>.

⁵¹ Mark Calabria, *Did Deregulation Cause the Financial Crisis*, CATO POL’Y REP., July-Aug. 2009, at 5, 7, *available at* <http://www.cato.org/policy-report/julyaugust-2009/did-deregulation-cause-financial-crisis>.

⁵² *The Risk in Clearing-Houses: All Clear?*, THE ECONOMIST (Apr. 7, 2012), <http://www.economist.com/node/21552209>.

⁵³ Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Remarks at the 2011 Financial Markets Conference (Apr. 4, 2011), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20110404a.pdf>; *see The Risk in Clearing-Houses: All Clear?*, *supra* note 53.

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In addition, recognizing the critical function that some non-financial entities use swaps to hedge risks associated with their underlying business, Congress added the “end-user exception” to mandatory clearing.⁵⁴ Section 723 of Dodd-Frank created an exception to mandatory clearing for swaps involving non-financial counterparties that are using swaps to hedge commercial risk.⁵⁵

As part of Dodd-Frank, the CFTC classified Dodd-Frank swap provisions for cross-border swaps into two categories; Entity-Level and Transactional-Level requirements.⁵⁶ Entity Level requirements are requirements that are applied to the firm as a whole.⁵⁷ Within the entity level category there are two sub-categories. The First Category includes capital adequacy, chief compliance officer,⁵⁸ risk management and data recordkeeping,⁵⁹ except recordkeeping relating to complaints and sales materials.⁶⁰ The Second Category includes SDR reporting,⁶¹ recordkeeping relating to complaints and sales materials,⁶² and Large Trading Reporting (LTR).⁶³

Transaction Level Requirements apply to individual swap transactions or trading relationships, and are determined on a transaction-by-transaction basis.⁶⁴ There are two categories, Category A and Category B. Category A involves Risk Mitigation and Transparency, and includes required clearing and swap processing,⁶⁵ margining and segregation for uncleared swaps,⁶⁶ mandatory trade execution,⁶⁷ swap trading relationship documentation,⁶⁸ portfolio reconciliation and compression,⁶⁹ real-time public reporting,⁷⁰

⁵⁴ See 7 U.S.C. § 2(h)(7)(C)(ii); see Press Release, Commodity Futures Trading Comm’n, Final Rule on End-User Exception to the Clearing Requirement for Swaps, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/eue_factsheet_final.pdf. Section 2(h)(7)(ii) of the CEA creates a small exemption for small banks, credit unions, savings associations and farm credit system institutions and makes them eligible for the end-user exception if they have total assets of \$10 billion or less. *Id.*

⁵⁵ 7 U.S.C. § 2(h)(7)(C)(ii). Section 2(h)(7)(C)(i) of the CEA defines a “financial entity” as a swap dealer, security-based swap dealer, major swap participant, major security-based swap participant, commodity pool, private fund, employee benefit plan, or any person that is predominantly engaged in activities of banking or activities that are financial in nature. *Id.* § 2(h)(7)(C)(i).

⁵⁶ Final Guidance *supra* note 5 at 45,331.

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* at 45,333; See 7 U.S.C. § 2(h)(1) requiring a swap to be submitted to a DCO, unless the swap or one of the parties fall within an accepted exception from the clearing requirement. 17 C.F.R. §§ 50.1-50.52.

⁶⁶ Final Guidance *supra* note 5 at 45,334; See 7 U.S.C. § 6s(e)(3)(C). CEA § 6s(e) requires the CFTC to set margin requirements for SDs and MSPs that trade swaps not subject to the clearing requirement. *Id.*

⁶⁷ Final Guidance *supra* note 5 at 45,334; See 7 U.S.C. § 2(h)(8). CEA § 2(h)(8) requires that all mandatorily cleared swaps must be executed on a DCM or SEF, unless no DCM or SEF accepts the swap. *Id.*

⁶⁸ Final Guidance *supra* note 5 at 45,334; 17 C.F.R. § 23.504 (2012).

⁶⁹ Final Guidance *supra* note 5 at 45,334; See 17 C.F.R. §§ 23.502, 23.503. Portfolio reconciliation is a post-execution risk management tool to ensure accurate confirmation of a swap’s terms and identify any discrepancies between counterparties. Portfolio compression is a post-trade processing and netting mechanism that is intended to ensure timely and accurate processing of swaps. *Id.*

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trade confirmation⁷¹ and daily trading records⁷². Category B involves external business conduct standards.⁷³

III. EXTRATERRITORIAL REACH OF TITLE VII

A. Section 2(i) of the CEA (amended by §722(d) of Dodd-Frank Act)

The CFTC's extraterritorial jurisdiction to regulate cross-border swaps comes from § 2(i) of the CEA, as amended by Section 722(d) of Dodd-Frank.⁷⁴ The CFTC was mandated by Dodd-Frank to (1) regulate swaps that "have a direct and significant connection in, or effect on, commerce of the U.S." and (2) prevent the evasion of the swaps provisions of Dodd-Frank.⁷⁵ In addition, Congress understood the complex nature of the derivatives market and that regulation of cross-border swaps would require cooperation and coordination among foreign regulators around the world.⁷⁶ As explained above, extraterritorial jurisdiction by the CFTC over cross-border swaps is important due to the fact that risk is rarely isolated and tends to have a substantial impact on the entire market.⁷⁷

It is universally accepted that there will be some form of extraterritorial jurisdiction over cross-border swaps by the CFTC.⁷⁸ However, there is a concern that the CFTC has gone too far in its interpretive guidance and policy statements.⁷⁹ CFTC Commissioner O'Malia is among those who disagree with the CFTC's guidance, stating multiple times that the CFTC failed to justify such a broad reach of extraterritorial jurisdiction for cross-border swaps.⁸⁰ O'Malia believes that Congress intended the phrase "direct and significant" to limit the

⁷⁰ Final Guidance *supra* note 5 at 45,335; *See generally* 17 C.F.R. §§ 43.1-7, 23.205. 7 U.S.C. § 2(a)(13) required the CFTC to promulgate rules providing for the public availability of swap transaction and pricing data on a real-time basis. *Id.*

⁷¹ Final Guidance *supra* note 5 at 45,335; *See generally* 17 C.F.R. § 23.501. 7 U.S.C. § 4s(i) requires SDs and MSPs to timely and accurately complete confirmations of swap transaction by the end of the first business day following the day of execution. *Id.*

⁷² Final Guidance *supra* note 5 at 45,335; 17 C.F.R. § 23.202.

⁷³ Final Guidance *supra* note 5 at 45,335; 7 U.S.C. § 2(a)(13)(A). Section 2(a)(13)(A) requires the CFTC to promulgate rules that establish business standards governing the conduct of SDs and MSPs with their counterparties to a swap. *Id.*

⁷⁴ *Id.* § 2(i) (amended by the Dodd-Frank Act §722(d)).

⁷⁵ *Id.*

⁷⁶ *See* Dodd-Frank Act, Pub. L. No. 111-203, § 752(a), 124 Stat. 1376, 1749 (2010). "In order to promote effective and consistent global regulation of swaps...the Commodity Futures Trading Commission...shall consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards with respect to the regulation (including fees) of swaps." *Id.*

⁷⁷ Gensler Keynote Address on Cross-border Application, *supra* note 1. "All of these common-sense reforms Congress mandated, however, could be undone if the overseas guaranteed affiliates and branches of U.S. persons are allowed to operate outside of these important requirements." *Id.*

⁷⁸ *See* Scott D. O'Malia, Commissioner, Commodity Futures Trading Comm'n, Keynote Address at the Global Forum for Derivatives Market: Regulatory Harmonization, Not Imperialism: A Workable Cross-Border Framework (Sept. 26, 2013), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-29> [hereinafter O'Malia Keynote Address].

⁷⁹ *Id.*

⁸⁰ *Id.*

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CFTC's authority, rather than bring the entire world under its jurisdiction.⁸¹ The EU's Financial Services Chief Michel Barnier expressed his discontent with the reach of the CFTC regulations and believes it will lead to further separation among regulators.⁸²

B. U.S. Person

The categorization as a "U.S. person" is a key factor in determining whether certain entities will be required to be in compliance with CFTC regulations and opt for the use of substituted compliance. The term "U.S. person" identifies any person or entity whose swap activities either individually or in the aggregate, could be expected to satisfy the jurisdictional nexus with the U.S. under section 2(i) of the CEA.⁸³ "U.S. persons" may include entities outside the U.S. if their swap activities have a "direct and significant connection" with the U.S.⁸⁴ The CFTC's definition of a "U.S. person" is critical to the determination of whether non-U.S. entities will be subject to the CFTC's registration requirement for swap dealers ("SD")⁸⁵ or major swap participants ("MSP")⁸⁶; and to determine whether a counterparty is a "U.S. person" under the CFTC definition.⁸⁷

The Interpretive Guidance released in July 2013 ("Final Guidance") largely adhered to the broad definition of U.S. persons given in the Proposed Guidance that was released the previous year, with limited changes and clarifications.⁸⁸ U.S. person is very broadly defined in the Final Guidance due to the prefatory phrase "includes, but not limited to," which was added to the initial definition in the Proposed Guidance.⁸⁹ Due to the prefatory language, the

⁸¹ *Id.*

⁸² Brunsden, *supra* note 43.

⁸³ See Final Guidance *supra* note 5 at 45,301.

⁸⁴ *Id.*

⁸⁵ *Id.* A "swap dealer" is any person who holds itself out as a dealer in swaps, makes markets in swaps, enters into swaps as ordinary course of business, or is commonly known in the trade as a dealer in swaps. Dodd-Frank Act § 721(49); see also Press Release, Commodity Futures Trading Comm'n, Final Rules Regarding Further Defining "Swap Dealer," "Major Swap Participant" and "Eligible Contract Participant," available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/msp_ecp_factsheet_final.pdf.

⁸⁶ Dodd-Frank Act, Pub. L. No. 111-203, § 721(a)(33), 124 Stat. 1376, 1663 (2010). A "major swap participant" is defined as a person who is not a swap dealer, and maintains a "substantial position" in any major swap category; whose outstanding swaps create "substantial counterparty exposure"; or is a highly leveraged "financial entity" not subject to capital requirements by a Federal banking entity and has a "substantial position" in any of the major swap categories. *Id.*

⁸⁷ See Final Guidance, *supra* note 5, at 45,301.

⁸⁸ *Id.* at 45,302. Under the Final Guidance, a U.S. person generally includes *but not limited to*:

Natural person residents of U.S.; Estates of decedent who was U.S. resident at time of death or trusts governed by U.S. law; Corporations organized or incorporated under U.S. laws; or all entities with principal place of business in U.S.; Entity pension plans; unless the pension plan is primarily for foreign employees. Trusts governed by the laws of a state or other U.S. jurisdiction Collective investment vehicles that is not described in (iii) and majority owned by a person described above; except for collective investment vehicles that are not publicly offered to U.S. persons. Legal entity (other than limited liability entities) that is majority owned by a person described above, and bears unlimited responsibility for the obligations and liabilities of the legal entity.

An individual or joint account where any beneficial owner is described above.

Id. (emphasis added).

⁸⁹ *Id.*

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Final Guidance evidently indicates that there may be a scenario where a person will not fall within the language of a U.S. person definition, yet could still be treated as a U.S. person.

Furthermore, the CFTC will treat the activities of foreign branches of U.S. banks as if they were that of the U.S. bank itself.⁹⁰ Accordingly, a foreign branch of a U.S. bank will be considered a U.S. person for the purposes of CFTC swap regulations.⁹¹ The Final Guidance emphasized the importance of including foreign branches of U.S. persons due to the fact that they “are neither separately incorporated nor separately capitalized and, more generally, the rights and obligations of a branch are rights and obligations of its principal entity.”⁹² The justification for including offshore funds that are majority-owned by U.S. persons is that the risk will flow back to the U.S. despite where their business address is listed.⁹³

A “foreign branch” under CFTC regulations is any foreign branch of a “U.S. person” that is: (i) subject to Regulation K or the FDIC International Banking Regulation, or otherwise designated as a foreign branch by the U.S. bank’s primary regulator, (ii) maintains accounts independently of the home office and of the accounts of other foreign branches with the profit or loss accrued at each branch determined as a separate item for each foreign branch, and (iii) subject to substantive regulation in banking or financing in the jurisdiction where it is located.⁹⁴ However, these factors may be modified by the CFTC, which stated that it will also consider “other relevant facts and circumstances.”⁹⁵

In order to determine whether a transaction conducted in a foreign branch of a U.S. person will be considered that of the foreign branch and thus subject to CFTC regulations, five factors must be present.⁹⁶ The five factors are:

- (i) the employees negotiating and agreeing to the terms of the swap (or, if the swap is executed electronically, managing the execution of the swap), other than employees with functions that are solely clerical or ministerial, are located in such foreign branch or in another foreign branch of the U.S. bank;
- (ii) the foreign branch or another foreign branch is the office through which the U.S. bank makes and receives payments and deliveries under the swap on behalf of the foreign branch pursuant to a master netting or similar trading agreement, and the documentation of the swap specifies that the office for the U.S. bank is such foreign branch;
- (iii) the swap is entered into by such foreign branch in its normal course of business;
- (iv) the swap is treated as a swap of the foreign branch for tax purposes;

⁹⁰ *Id.* at 45315.

⁹¹ *Id.*

⁹² *Id.*

⁹³ See Randolph Walerius, *O’Malia Urges CFTC to Delay Cross-Border Swaps Regulation Until Dec. 31, 2013*, 2013 WL 72449246.

⁹⁴ Final Guidance, *supra* note 5, at 45329.

⁹⁵ *Id.*

⁹⁶ *Id.* at 45,330.

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and

(v) the swap is reflected in the local accounts of the foreign branch.⁹⁷

In addition to foreign branches there are two types of entities, “guaranteed affiliates” and “affiliate conduits,” that are not explicitly listed in the definition of “U.S. person.”⁹⁸ Nevertheless, they may be treated as such. “Guaranteed affiliates” are non-U.S. affiliates of U.S. persons that are guaranteed by a U.S. person.⁹⁹ On the other hand, “affiliate conduits” are entities that function as a conduit or vehicle for a U.S. person conducting swap transactions with third-party counterparties.¹⁰⁰ The CFTC justified its decision to regulate such entities, based on its claim to have the requisite statutory nexus and that the ultimate risk created by them are placed on U.S. persons.¹⁰¹

C. CFTC’s Choice of Interpretive Guidance Over Formal Rulemaking

Beginning in 2012, the CFTC began to issue interpretive guidance and policy statements outlining the methods by which it will apply the changes Dodd-Frank made to the CEA concerning cross-border swaps regulations.¹⁰² The CFTC chose to promulgate its regulations through this interpretive guidance rather than formal rulemaking.¹⁰³ The CFTC regarded its Interpretive Guidance to be “a statement of the [CFTC’s] general policy regarding cross-border swap activities and allows for flexibility in application to various situations, including consideration of all relevant facts and circumstances that are not explicitly discussed in the guidance.”¹⁰⁴

This unconventional approach to rulemaking taken by the CFTC avoids many of the cost-benefit analysis requirements of the CEA and formal requirements of the Administrative Procedure Act (“APA”).¹⁰⁵ Had the CFTC chosen to undertake formal rulemaking, it would have been required to determine the economic implications of each rule and make public the results of the cost-benefit analysis.¹⁰⁶ Commissioner O’Malia, in his dissent from the Final Guidance, expressed that the CFTC’s approach to rule promulgation “crosse[d] the line

⁹⁷ *Id.*

⁹⁸ *Id.* at 45,302.

⁹⁹ *Id.* at 45,318.

¹⁰⁰ *Id.* at 45,359. Affiliate conduits will be determined as a “U.S. person” based on four factors, (1) majority ownership, (2) control, (3) consolidated financial statements, and (4) the regular course of business of the non-U.S. person. *Id.*

¹⁰¹ *Id.* at 45,318.

¹⁰² *Id.* at 45,297. The guidance is intended to set forth “the general policy of the [CFTC] in interpreting how section 2(i) of the CEA provides for the application of the swaps provisions of the CEA and [CFTC] regulations to cross-border activities when such activities have a ‘direct and significant connection with activities in, or effect on, commerce of the United States’ or when they contravene [CFTC] rulemaking.” *Id.*

¹⁰³ *Id.* The SEC took the opposite approach than the CFTC, and has been issuing formal rules for its mandate under Dodd-Frank. See Cross-Border Security-Based Swap Activities, Exchange Act Release No. 34-69490, File Nos. S7-02-13, S7-34-10, S7-40-11 (May 1, 2013), available at <http://www.sec.gov/rules/proposed/2013/34-69490.pdf>.

¹⁰⁴ Final Guidance, *supra* note 5, at 45,297.

¹⁰⁵ See *id.* at 45371, 45372 (dissenting Statement of Comm’r Scott D. O’Malia).

¹⁰⁶ Bus. Roundtable & Chamber of Commerce of U.S. v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (quoting Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)).

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between interpretive guidance and rulemaking.”¹⁰⁷ The D.C. Circuit Court has held that when agency guidance has a binding effect on market participants it has the force of law and should be promulgated in accordance with the APA.¹⁰⁸ On December 4, 2013, three Wall Street trade groups, Securities Industry and Financial Markets Association (“SIFMA”), the International Swaps and Derivatives Association, Inc. (“ISDA”), and the Institute of International Bankers (“IIB”), filed suit against the CFTC challenging its method of cross-border rule promulgation through guidance in order to circumvent APA requirements.¹⁰⁹ This suit has the potential to unravel the regulatory framework the CFTC has created, and in turn delivering a severe blow to the derivatives market regulation in the U.S.

D. CFTC Guidelines for the Application of the CEA to Cross-Border Swaps

On July 12, 2012, the CFTC issued its initial proposed guidance (“Proposed Guidance”) for certain cross-border swap provisions of the CEA.¹¹⁰ The CFTC divided the regulatory requirements applicable to non- U.S. registrants into two categories: “Entity-Level” requirements and “Transactional-Level” requirements.¹¹¹ Transactional-level requirements will affect both parties to a swap, whereas with entity-level requirements only the covered entity is liable for compliance.¹¹² As previously stated, in its initial Proposed Guidance, the CFTC issued a broad interpretation of U.S. person, which allowed for many transactions outside the U.S. to fall within its regulatory jurisdiction.¹¹³ The CFTC has continued to issue guidance papers and CFTC Staff Letters on the application of extraterritorial and cross-border swaps.¹¹⁴

Recognizing the importance and the global nature of the derivatives market, the CFTC and EU released a joint press release on July 11, 2013 addressing how to approach cross-border derivatives (“Path Forward”).¹¹⁵ Specifically, the CFTC announced the application of Transaction-Level Requirements on a “territorial basis” and its intention to allow for substituted compliance with the E.U. for entity-level requirements.¹¹⁶ In addition, the CFTC announced the use of a “stricter-rule-applies” approach to cross-border transactions in order to avoid regulatory arbitrage.¹¹⁷ EMIR’s derivative risk mitigation rules are deemed to be equivalent to the CFTC’s business conduct standards and the CFTC agreed to issue No-

¹⁰⁷ Final Guidance, *supra* note 5, at 45,371 (dissenting statement of Commissioner Scott D. O’Malia).

¹⁰⁸ *Appalachian Power Co. v. E.P.A.*, 208 F.3d 1015, 1020 (D.C. Cir. 2000); *Gen. Elec. Co. v. EPA*, 290 F.3d 377, 383 (D.C. Cir. 2002); *see also A & E Coal Co. v. Adams*, 694 F.3d 798, 801 (6th Cir. 2012).

¹⁰⁹ *See generally* Complaint, *Sec. Indus. and Fin. Mkt. Ass’n, et. al v. U.S. Commodity Futures Trading Comm’n*, (No. 13-CV-1916).

¹¹⁰ Proposed Guidance, *supra* note 57, at 41,214.

¹¹¹ *Id.* at 41,223-26.

¹¹² *Id.*; *see also* Greene & Potiha, *supra* note 19, at 343.

¹¹³ Proposed Guidance, *supra* note 57, at 41,218.

¹¹⁴ *See, e.g.*, Final Guidance, *supra* note 5.

¹¹⁵ Press Release, Commodity Futures Trading Comm’n, The European Commission and the CFTC Reach a Common Path Forward on Derivatives (July 11, 2013), *available at* <http://www.cftc.gov/PressRoom/PressReleases/pr6640-13> [hereinafter Path Forward].

¹¹⁶ *Id.*

¹¹⁷ *Id.*

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Action Relief in that regard.¹¹⁸ Finally, the CFTC extended appropriate time-limited transitional relief to certain EU-regulated multilateral trading facilities.¹¹⁹

Since the release of the Path Forward, the CFTC has issued additional guidance and staff letters further expanding on its rules. The EU was “surprised” by these new rules released since the Path Forward, which appear to “go against both the letter and spirit of the path forward agreement.”¹²⁰ Chief Michel Barnier, the spokeswoman for EU’s Financial Services, stated that the new rules “are another step away from the kind of inter-operable global system that we want to build.”¹²¹ “We are starting to see the impact of the lack of alignment between EU and U.S. rules on derivatives, in terms of higher costs of transactions and fragmentation of markets.”¹²²

On July 26, 2013, the CFTC issued its “Final Guidance” regarding the cross-border application of swaps provisions of Dodd-Frank and the CEA.¹²³ The Final Guidance and Exemptive order from July 26, 2013 addressed issues regarding: the definition of a U.S. person; the framework for calculation and aggregation methods for determining *de minimis* SD and MSP thresholds; the treatment of “foreign branch” of U.S. SDs and MSPs; treatment of swaps involving non-U.S. counterparty guaranteed by U.S. person or affiliate conduit; requirements for non-registered swap participants; entity and transaction level requirement extraterritorial applications and a framework for substituted compliance.¹²⁴

On December 20, 2013, the CFTC released its first comparability determinations for substituted compliance in six jurisdictions.¹²⁵ Working in conjunction with the foreign regulatory authorities, the CFTC approved a broad range of entity-level requirements for all six jurisdictions.¹²⁶ The CFTC went further for two jurisdictions, the EU and Japan, and approved additional transaction-level requirements.¹²⁷

IV. SUBSTITUTED COMPLIANCE

A. Introduction

Substituted compliance is the process by which the CFTC will allow for certain CFTC regulations to be deemed satisfied if a foreign entity complies with its home

¹¹⁸ *Id.*

¹¹⁹ *Id.*

¹²⁰ Brunsden, *supra* note 43.

¹²¹ *Id.*

¹²² *Id.*

¹²³ Final Guidance, *supra* note 5.

¹²⁴ *Id.*

¹²⁵ Press Release, Commodity Futures Trading Comm’n, CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes (Dec. 20, 2013), *available at* <http://www.cftc.gov/PressRoom/PressReleases/pr6802-13>. The six jurisdictions include: Australia, Canada, the European Union, Hong Kong, Japan and Switzerland. *Id.*; *see also* *Comparability Determinations for Substituted Compliance Purposes*, U.S. COMMODITY FUTURES TRADING COMM’N, <http://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm> (last visited Oct. 7, 2014). CFTC comparability determinations for substituted compliance will be made available on the CFTC’s website. *See, e.g., id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

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jurisdiction's regulations.¹²⁸ Generally, there is a presumption against extraterritorial application of U.S. regulations.¹²⁹ The Restatement (Third) of Foreign Relations Law of the U.S. states that, where a country has a basis for jurisdiction, it should not prescribe law with respect to a person or activity in another country when the exercise of such jurisdiction is unreasonable.¹³⁰ Furthermore, in *Morrison v Nat'l Australian Bank Ltd.* the Supreme Court recently reiterated this point and held that as a canon of American law there is a presumption against extraterritorial application of U.S. law.¹³¹ Moreover, Commissioner O'Malia and other foreign regulators have stated their beliefs that the CFTC failed to justify such a broad interpretation by the CFTC for extraterritorial jurisdiction of cross-border swaps.¹³² O'Malia stressed that Congress intended the phrase "direct and significant" to limit the CFTC's authority, rather than bring the entire world under its jurisdiction.¹³³

Despite this presumption, Congress clearly indicated in Dodd-Frank its intent that the CFTC have some form of extraterritorial jurisdiction.¹³⁴ Every registered SD or MSP will have to comply with all applicable CFTC swap requirements.¹³⁵ However, under certain circumstances the CFTC will allow for substituted compliance with foreign regulators.¹³⁶ Substituted compliance is the method by which the CFTC will make certain determinations that a specific foreign law or regulation is comparable and comprehensive to its corresponding U.S. law or regulation.¹³⁷ Once the CFTC makes such a determination, an entity or transaction that complies with that foreign law or regulation will be deemed to be in compliance with the corresponding U.S. law or regulation.¹³⁸ Even under substituted compliance, the CFTC retains both examination and enforcement authority.¹³⁹

However, instead of complying with CFTC swap regulations, the substituted compliance regime allows foreign entities to apply for an exemption from CFTC registration.¹⁴⁰ Exemptions will be based on a foreign entity's compliance with substantively comparable foreign regulations and supervision by a foreign regulator.¹⁴¹ The foreign

¹²⁸ See Final Guidance, *supra* note 5, at 45,342. Only certain entities that do not fall within the immediate jurisdiction of the CFTC will be eligible to opt for the use of substituted compliance. *Id.* at 45,344.

¹²⁹ RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW OF THE U.S. § 403(1) (1987).

¹³⁰ *Id.*

¹³¹ *Morrison v. Nat'l Austl. Bank Ltd.*, 130 S. Ct. 2869, 2878, 177 L. Ed. 2d 535 (2010) (stating that the presumption against extraterritorial application of U.S. law could be overruled by clear statements by Congress, and regarding Dodd-Frank Congress chose to do so).

¹³² *E.g.*, O'Malia Keynote Address, *supra* note 79.

¹³³ *Id.*

¹³⁴ Dodd-Frank Act, Pub. L. No. 111-203, § 722, 124 Stat. 1376, 1672 (2010); 156 CONG. REC. H5237 (daily ed. June 30, 2010) (statement of Rep. Kanjorski), available at <http://www.gpo.gov/fdsys/pkg/CREC-2010-06-30/pdf/CREC-2010-06-30-pt1-PgH5233.pdf>; see *supra* Part III.A.

¹³⁵ See *Swap Dealer (SD)*, U.S. COMMODITY FUTURES TRADING COMM'N, <http://www.cftc.gov/IndustryOversight/Intermediaries/SDs/index.htm> (last visited Dec. 18, 2014); see also *Major Swap Participant (MSP)*, U.S. COMMODITY FUTURES TRADING COMM'N, <http://www.cftc.gov/IndustryOversight/Intermediaries/MajorSwapParticipantMSP/index.htm> (last visited Dec. 18, 2014).

¹³⁶ See *infra* Part IV.C; see also Final Guidance, *supra* note 5, at 45,342.

¹³⁷ Final Guidance, *supra* note 5, at 45,344.

¹³⁸ See *infra* Part IV.C; see also Final Guidance, *supra* note 5, at 45,342.

¹³⁹ Final Guidance, *supra* note 5, at 45,342-44.

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

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regulators will be required to have oversight powers and a regulatory enforcement philosophy substantively similar to the CFTC's.¹⁴² Further, even if the CFTC permits the use of substituted compliance for an individual entity, the CFTC will not relinquish its power to punish and pursue violations.¹⁴³

The goal of substituted compliance is to avoid regulatory arbitrage, eliminate duplicative compliance cost, and lower programmatic cost for foreign registered SDs associated with the implementation of compliance with Title VII requirements. As noted above, the CFTC issued the Path Forward, a joint press release with the EU, recognizing the importance of regulatory harmonization.¹⁴⁴ The Path Forward discusses the global nature of the swaps market and the similarities among the regulatory requirements between the U.S. and EU.¹⁴⁵ The use of substituted compliance is supported by the release, since it notes that "simultaneous application of each other's requirements" would result in "conflicts of law, inconsistencies and legal uncertainty" among entities and regulators.¹⁴⁶

B. Model for Extraterritorial Application of Cross-border Regulations

Having a model, or, at the very least, a general understanding of how the CFTC will implement and apply substituted compliance is vital to successfully implementing Dodd-Frank regulations. The statutory language used in the CEA § 2(i)¹⁴⁷ is very similar to the language used in the Foreign Trade Antitrust Improvements Act of 1982 ("FTAIA"),¹⁴⁸ which provides the standard for cross-border application of the Sherman Antitrust Act.¹⁴⁹ CEA § 2(i) mandates the CFTC to regulate swaps that "have a *direct* and significant connection in, or effect on, commerce of the U.S."¹⁵⁰

Although the terms in the CEA and FTAIA are similar, only the term "direct" appears in both.¹⁵¹ The Supreme Court has not addressed the meaning of "direct" under FTAIA, but they have under the Foreign Sovereign Immunities Act ("FSIA").¹⁵² The Ninth Circuit has interpreted the term "direct" in the FTAIA as requiring a "'relationship of logical causation,' such that 'an effect is 'direct' if it follows as an immediate consequence of the defendant's activity.'"¹⁵³ In contrast, the Seventh Circuit opined that the Ninth Circuit was too quick to assume that FSIA is equivalent to FTAIA.¹⁵⁴ The Seventh Circuit held that "direct" means only a "reasonable proximate *causal* nexus," as articulated by the Department of

¹⁴² *Id.*

¹⁴³ Final Guidance, *supra* note 5, at 45,342-44; *see id.*

¹⁴⁴ Path Forward, *supra* note 114; *see also supra* Part III.D.

¹⁴⁵ Path Forward, *supra* note 114.

¹⁴⁶ *Id.*

¹⁴⁷ *See supra* Part III.A. Section 2(i) allows for jurisdiction for activities outside the U.S. that have a "direct and significant connection...or effect on" U.S. commerce. 7 U.S.C. § 2(i).

¹⁴⁸ 15 U.S.C. § 6a. "[T]his title shall not apply to conduct involving trade or commerce...with foreign nations unless...such conduct has a direct, substantial and reasonably foreseeable effect...on trade or commerce." *Id.*

¹⁴⁹ *Id.* § 1-7.

¹⁵⁰ 7 U.S.C. § 2(i) (as amended by Dodd-Frank § 722(d)) (emphasis added).

¹⁵¹ *Id.*; 15 U.S.C. § 6a; *see* Final Guidance, *supra* note 5, at 45,299.

¹⁵² Final Guidance, *supra* note 5, at 45,298.

¹⁵³ *U.S. v. LSL Biotechnologies*, 379 F.3d 672, 680 (9th Cir. 2004).

¹⁵⁴ *Minn-Chem, Inc. v. Agrium Inc.*, 683 F.3d 845, 857 (7th Cir. 2012).

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Justice Antitrust Division, rejecting any interpretation which included a requirement of foreseeable, substantial or immediate consequences.¹⁵⁵

While the FTAIA and CEA Section 2(i) are not identical, there are more terms that differentiate the two than only the word “direct.”¹⁵⁶ Nevertheless, the CFTC stated that it will interpret the term “direct” as written in the CEA section 2(i) in accordance with the meaning under FTAIA as interpreted by the Department of Justice Antitrust Division and the Seventh Circuit which does not require foreseeability, substantially or immediacy.¹⁵⁷ Congress’s decision to expressly decline to include in CEA section 2(i) FTAIA’s standards of substantiality, immediacy, or foreseeability demonstrates Congress’s intent that Dodd-Frank should have a more expansive jurisdictional application than FTAIA.¹⁵⁸

C. How Will the CFTC Apply Substituted Compliance?

The CFTC will apply an “outcome based” approach to determine whether certain foreign regulatory requirements are comparable to and as comprehensive as Dodd-Franks normative objectives (i.e. entity and transactional requirements).¹⁵⁹ The CFTC will not require identical requirements in the foreign jurisdiction. Rather, the CFTC will make determinations based on a requirement-by-requirement basis in lieu of a determination based on the foreign regulations as a whole.¹⁶⁰ In the Path Forward, the CFTC stated that it would generally use a “stricter-rule-applies” approach while making substituted compliance determinations.¹⁶¹

While considering the comparability of foreign laws and regulations, the CFTC will consider the following factors: the comprehensiveness of those requirements, the scope and objectives of the requirements, the foreign regulators supervisory compliance programs and its authority to support and enforce oversight.¹⁶² The CFTC only requires foreign rules and regulations to be comparable, but not identical to its CFTC counterpart regulation.¹⁶³

Applications for a comparability determination are expected to take into account, the factual and legal basis for requesting such a determination, a particular Dodd-Frank requirement, including with specificity all applicable legislation, rules and policies, and provide an assessment whether the objectives of the two regulatory regimes are comparable and comprehensive.¹⁶⁴

Once a substituted compliance determination has been made, the CFTC stated it will likely enter into a memorandum of understanding (“MOU”) with a foreign regulator or

¹⁵⁵ *Id.* at 856-57.

¹⁵⁶ See Final Guidance, *supra* note 5, at 45298. The FTAIA explicitly requires that the effect on U.S. commerce be “reasonably foreseeable” as a result of the conduct, while there is no explicit foreseeability requirement in the CEA. The CEA also uses the language of “effect” and “connection,” where “connection” is not listed in the FTAIA. *Id.* at 45,299.

¹⁵⁷ *Id.* at 45,300.

¹⁵⁸ *Id.* at 45,299.

¹⁵⁹ *Id.* at 45,342; see generally Path forward, *supra* note 114.

¹⁶⁰ Final Guidance, *supra* note 5, at 45,343.

¹⁶¹ Path Forward, *supra* note 114.

¹⁶² Final Guidance, *supra* note 5, at 45,343.

¹⁶³ *Id.* at 45,342.

¹⁶⁴ *Id.* at 45,344.

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another similar arrangement.¹⁶⁵ Applicants would have to notify the CFTC of any material changes made that could affect the comparability determination.¹⁶⁶ The CFTC will also reevaluate each initial determination within four years of its issuance, in order to decide whether certain changes should be made to its determination.¹⁶⁷

Any non-U.S. person who is registered as a SD or MSP may be eligible for substituted compliance.¹⁶⁸ The CFTC will accept comparability determination applications from foreign regulators, individuals or groups of non-U.S. entities, U.S. banks that are a SD or MSP with respect to its foreign branches, or any other trade association or similarly situated entities.¹⁶⁹

Entities deemed U.S. persons will generally not be eligible to opt for substituted compliance and will have to comply with all entity-level requirements and transaction-level requirements.¹⁷⁰ However, swaps between a foreign branch of a U.S. person and a non-U.S. person should be eligible for substituted compliance for Category A Transaction-Level Requirements.¹⁷¹ The CFTC will allow substituted compliance for this type of swap in order to assure that foreign entities would not avoid or cease to do business with foreign branches of U.S. registered SDs.¹⁷²

A non-U.S. SD or MSP is generally required to be in compliance with all Entity-Level Requirements. However, substituted compliance may be permitted in some instances, depending on whether the particular requirement in question is in the First Category of Entity-Level Requirements, or the Second Category.¹⁷³ Additionally, for some requirements, such as SDR reporting, the CFTC's substituted compliance determination regarding particular swaps will depend on whether the SD or MSP's counterparty is, or is not, a U.S. person.¹⁷⁴

Substituted compliance may also be available to non-U.S. SDs or MSPs for Transaction-Level Requirements.¹⁷⁵ This determination will mainly depend upon the status of the counterparties. If the counterparty is a U.S. person, substituted compliance will not be permitted, unless the swap was executed anonymously between a non-U.S. person and a U.S. person on a Designated Contract Market ("DCM") or Swap Execution Facility ("SEF"), and cleared, satisfying Category A Transaction-Level Requirements.¹⁷⁶ On the other hand, if the counterparty is not a U.S. person, neither the Category A Transaction-Level Requirements nor any substituted compliance is necessary.¹⁷⁷

However, where a swap is between a non-U.S. SD or MSP and a non-U.S. Person guaranteed by, or affiliate conduit of, a U.S. Person, both parties will be required to either comply with Category A Transaction-Level Requirements or file for substituted

¹⁶⁵ *Id.*

¹⁶⁶ *Id.* at 45,345.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 45,344.

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 45,368.

¹⁷¹ *Id.* at 45,329.

¹⁷² *Id.*

¹⁷³ *Id.* at 45,348-50; *Id.* at 45,331-33.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.* at 45,369 (app. D).

¹⁷⁶ *Id.*

¹⁷⁷ *Id.*

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compliance.¹⁷⁸ But if the counterparty is not guaranteed by, or affiliate conduit of, a U.S. person, the non-U.S. SD or MSP will not be required to comply with Category A Transaction-Level Requirements in any way.¹⁷⁹ Substituted compliance is also available for Category A Transaction-Level requirements between non-U.S. persons and foreign branches of U.S. Banks that are SDs or MSPs.¹⁸⁰

For Category B Transaction-Level Requirements,¹⁸¹ non-U.S. persons will only be required to be in compliance, when the counterparty is a U.S. person. For swaps executed anonymously between a non-U.S. person and a U.S. person on a DCM or SEF and cleared, non-U.S. SDs or MSPs will not be required to comply with Category B, regardless of the counterparty's status.¹⁸²

V. SUBSTITUTED COMPLIANCE IS THE MOST APPROPRIATE APPROACH FOR CFTC TO COMPLETE ITS GOALS

A. What are the Benefits of Using Substituted Compliance

Substituted compliance will help the CFTC achieve the objective of the G20 and Dodd-Frank, by harmonizing global regulations by the most efficient means possible. This is critical because "The absence of [global] harmonization could result in potential conflict, regulatory arbitrage and undermine the competitive position of entities or counterparties in the US."¹⁸³ Substituted compliance will not only be beneficial to the CFTC, but to market participants as well.

The CFTC has been placed under budget constraints that create certain difficulties and obstacles to fulfilling its mandate under Dodd-Frank.¹⁸⁴ The operating budget for the CFTC for FY 2014 stands at \$315 million,¹⁸⁵ while a single market participant that the CFTC

¹⁷⁸ *Id.*

¹⁷⁹ *Id.*

¹⁸⁰ *Id.*

¹⁸¹ *Id.* at 45,335.

¹⁸² *Id.* at 45,369 (app. E).

¹⁸³ Greene & Potiha, *supra* note 19, at 340.

¹⁸⁴ Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n, Testimony of Chairman Gary Gensler Before the U.S. Senate Appropriations Subcommittee on Financial Services and General Government, Washington, DC (June 25, 2013), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-142>. Gary Gensler, Chairman, Commodity Futures Trading Comm'n, Remarks of Chairman Gary Gensler at the 2013 Annual Glauber Lecture at Harvard University (Oct. 29, 2013), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-149> [hereinafter Gensler Remarks]. The budget appropriations for FY 2014 was significantly less than the \$315 million budget that President Obama and Chairman Gensler requested from the Senate Appropriations subcommittee. *Id.* See Lynch *infra* note 187. The CFTC Division of Enforcement collected over \$1.7 billion in sanctions. Press Release, CFTC Releases Enforcement Division's Annual Results, Commodity Futures Trading Comm'n (Oct. 24, 2013), *available at* <http://www.cftc.gov/PressRoom/PressReleases/pr6749-13>. There have been recent appeals made that the CFTC become self-funded. The CFTC is the only financial regulatory authority that does not fund itself, even partially, through sanctions and penalties. David Dayen, *Congress Is Starving the Agency That's Supposed to Prevent Another Meltdown*, NEW REPUBLIC (Nov. 7, 2013), <http://www.newrepublic.com/article/115511/cftc-funding-will-prevent-it-regulating-derivatives>.

¹⁸⁵ *See id.*

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is supposed to oversee spends over ten times as much, \$2.4 billion, on their information technology budget alone.¹⁸⁶

Since the enactment of Dodd-Frank, the markets the CFTC is mandated to regulate has jumped from \$40 trillion to \$340 trillion.¹⁸⁷ However, the CFTC has a staff of only 672, which is 40 more employees than it had 20 years ago.¹⁸⁸ Former Chairman Gensler has stated that in order to properly oversee the markets it would require an additional 300 people on its staff.¹⁸⁹ Both Gensler and former CFTC enforcement chief David Meister have stated that they had to delay or forgo enforcement cases due to lack of funding.¹⁹⁰ “The larger the market the more difficult it is to monitor,”¹⁹¹ therefore providing a framework for the CFTC to rely on trusted foreign regulators will be beneficial to the CFTC and its overburdened staff.

Not only would substituted compliance help the CFTC’s strained staff, by eliminating duplicative compliance costs, but it could also help by incurring lower programmatic cost associated with implementation of compliance with Title VII requirements and avoid regulatory arbitrage for SDs. The absence of substituted compliance may impose overlapping, repetitious or possibly contradictory obligations imposed on foreign entities operating in the U.S. and increase transaction costs for U.S. investors, while offering only marginal improvements in investor protection.¹⁹²

Others have theorized that by allowing substituted compliance and working in conjunction with foreign regulators who share a similar regulatory philosophy, the CFTC may be able to leverage its regulatory strength.¹⁹³ Due to the size and impact of U.S. capital markets, substituted compliance can be used as a means of encouraging foreign jurisdictions with lax or negligible regulations to adopt higher regulatory standards.¹⁹⁴ This would also reduce the incentive of foreign regulators to attract business away from the U.S. and its partners through the use of regulatory arbitrage.¹⁹⁵ Substituted compliance would strong-arm foreign regulators with weak regulatory systems to raise their standards in accordance with the highest international standards in order to provide their entities with access to the largest and most powerful markets in the world.¹⁹⁶ However, trades conducted outside of U.S. jurisdiction, without approved regulatory oversight, will be limited to the remedies available

¹⁸⁶ Sarah Lynch, *UPDATE 1-Wall Street Regulators Face Budget Crunch Under New Spending Deal*, REUTERS (Jan. 14, 2014, 9:04 PM) <http://www.reuters.com/article/2014/01/15/financial-regulation-budget-idUSL2N0KP03120140115/>; Dayen, *supra* note 185.

¹⁸⁷ Gensler Remarks, *supra* note 185.

¹⁸⁸ Matthew Phillips, *The CFTC is Drowning in Market Data*, BLOOMBERG BUS. WK. (Oct. 31, 2013), <http://www.businessweek.com/articles/2013-10-31/the-cftc-is-drowning-in-swaps-futures-trading-data#p1>.

¹⁸⁹ CFTC Chairman Talks Regulation (Fox Business television broadcast Nov. 19, 2013), *available at* <http://video.foxbusiness.com/v/2851312695001/cftc-chairman-talks-regulation/>.

¹⁹⁰ *Id.*; Dayen, *supra* note 185. One of the cases in which the CFTC declined to file charges against due to lack of fund included to JPMorgan Chase traders involved in the “London Whale” case. *See* Dayen, *supra* note 185.

¹⁹¹ Yuliya Guseva, *Cross-Listings and the New World of International Capital: Another Look at the Efficiency and Extraterritoriality of Securities Law*, 44 GEO. J. INT’L L. 411, 489 (2013).

¹⁹² Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 Harv. Int’l L.J. 31, 32 (2007).

¹⁹³ *See id.* at 56.

¹⁹⁴ *Id.*

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* at 57.

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under the foreign regulatory protections and not be afforded U.S. protections that many of them desire.¹⁹⁷

B. What are the Risks of Using Substituted Compliance

While overall there are many benefits to the application of substituted compliance, there are certain limitations and risks associated with substituted compliance that should be explored. One point of concern is that it is merely a “very shrewd strategy” that the derivative industry came up with in order to “play a giant game of regulatory arbitrage[...].”¹⁹⁸ Ultimately, major banks will still move their high-risk activities offshore, which will nullify anything that is in Dodd-Frank.¹⁹⁹ If substituted compliance causes major banks to move their high-risk activities offshore, the effectiveness of a Dodd-Frank provision will be nullified.²⁰⁰ “Foreign regulators have said the CFTC’s guidance puts swap market participants in the position of having to choose which laws to break.”²⁰¹

Another potentially negative result is that “global entities may be forced to insulate their U.S. business from the rest of their global activity, which would significantly increase costs and risks to firms and their customers.”²⁰² This could ultimately lead to a decrease in market activity in the U.S. and have a negative effect on our slow growing economy. Other U.S. businesses have expressed concern that an expansive extraterritorial application of Title VII could create severe disadvantages for U.S. firms.²⁰³ If Title VII applies to U.S. firms’ overseas operations, but not to their foreign competitors, U.S. firms may lose a significant amount of business.²⁰⁴

C. Comparison of Substituted Compliance to Other Regulatory Approaches for Cross-Border Swaps

The CFTC has stated that it will use a substituted compliance approach for the application of cross-border swap regulations, however, other regulators are trying different methods. Two common approaches that other foreign regulators are using include mutual recognition and the equivalence standard.²⁰⁵ The regulatory standards used by Europe and

¹⁹⁷ *Id.*

¹⁹⁸ *John Coffee on Regulatory Arbitrage and Substituted Compliance*, CORP. CRIME REP. (Sept. 17, 2013, 5:49 AM), <http://www.corporatecrimereporter.com/news/200/johncoffeeregulatoryarbitrage09172013/>.

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ Walerius, *supra* note 94.

²⁰² *Limiting the Extraterritorial Impact of Title VII of the Dodd-Frank Act: Hearing Before the Subcomm. On Capital Mkts & Gov’t Sponsored Enters. of the Comm. on Fin. Servs.*, 112th Cong. 8 (2012) (statement of Chris Allen, Managing Director, Barclays Bank PLC), available at <http://financialservices.house.gov/uploadedfiles/112-100.pdf>.

²⁰³ *Id.* at 12 (statement of Don Thompson, Managing Dir. and Assoc. Gen. Counsel, JP Morgan Chase & Co.).

²⁰⁴ *See id.*

²⁰⁵ Pierre-Hugues Verdier, *Mutual Recognition in International Finance*, 52 HARV. INT’L L.J. 56, 57 (2011); Christopher Bernard & Jonathan D. Gupta, *Regulating Derivatives Across Borders: The Latest Developments in the United States and the European Union*, WORLD SEC. L. REP. (Oct. 11, 2013), available at <http://www.bloomberglaw.com/search/results/96fceb7540944d034bc6f2d5eef19a0a/document/X2GRCHC8000000>.

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other foreign regulators are important, because if they are deemed insufficient the CFTC will not allow for substituted compliance with entities within that jurisdiction.²⁰⁶

The EU will use an equivalence standard to determine the application of European Market Infrastructure Regulation (“EMIR”)²⁰⁷ regulations on cross-border swaps. The European Securities and Markets Authority (“ESMA”) will determine whether a non-EU country has laws, supervision and enforcement requirements equivalent to that of EMIR.²⁰⁸ The principles of substituted compliance are similar to that of the equivalence standard, however the scope and application mechanisms are different.²⁰⁹ Under the equivalence standard, ESMA “recommended a finding of equivalence where the gaps did not undermine the consistency of objectives.”²¹⁰ If the non-EU country is deemed to have equivalent regulations, entities in that country will be allowed to comply with its home country’s regulation, similar to substituted compliance.²¹¹ An outcome-based approach to substituted compliance is close to an equivalence standard because it does not make determinations on a detailed line-by-line comparison of each rule. That being said, an equivalence standard is most similar to mutual recognition, in that it relies on reciprocity.²¹²

The SEC received a similar mandate to that of the CFTC under Dodd-Frank, to regulate security-based swaps (“SB swaps”).²¹³ The SEC adopted a comparable process for cross-border regulation as the CFTC, however, there are several key distinctions between the two. The SEC has stated that its approach would be more “holistic” and that they will not conduct a “rule-by-rule” analysis in each jurisdiction.²¹⁴ Instead, the SEC will consider the “regulatory outcomes,” similar to the equivalence standard of the EU.²¹⁵ The SEC will allow for its version of substituted compliance within four categories of SEC requirements: requirements regarding registration of SB swaps dealers, reporting and public availability of SB swap data, clearing requirements, and trade execution requirements.²¹⁶ Although the

²⁰⁶ See Final Guidance, *supra* note 5.

²⁰⁷ Adam Litke, *EMIR Is More Limited in Transparency, Real-Time Prices Than U.S. Derivatives Rules*, BLOOMBERG BRIEF FINANCIAL REGULATION (Bloomberg, New York, N.Y.), Feb. 4, 2014, at 5, available at http://www.bloombergbriefs.com/content/uploads/sites/2/2014/07/FinReg_EMIR_final-3.pdf. EMIR is the EU’s legislation in reaction to the goals set by the G20 in Pittsburg and has many similarities to Dodd-Frank in the US. See *id.*

²⁰⁸ Sean Donovan-Smith, et al., *The Extraterritorial Impact of the EU’s OTC Derivatives Regulation on Non-EU Swap Counterparties*, WORLD SEC. L. REP. (Jan. 10, 2014), available at <http://www.bloomberglaw.com/document/X9JHF90K000000?campaign=bnaemailink&issue=20131223&jcsearch=bna%2520a0e4k4v3j8&js=0&sitename=bna&subscriptiontype=bnawslr#jcite>.

²⁰⁹ *Id.*

²¹⁰ Bernard & Gupta, *supra* note 206.

²¹¹ Donovan-Smith, et al., *supra* note 209.

²¹² Greene & Potiha, *supra* note 19, at 370.

²¹³ 15 U.S.C. § 8302(a); Section 712(a)(2) of Dodd-Frank states “the Securities and Exchange Commission shall consult and coordinate to the extent possible with the Commodity Futures Trading Commission and the prudential regulators for the purposes of assuring regulatory consistency and comparability, to the extent possible.” Dodd-Frank Act, Pub. L. No. 111-203, §712(a)(2), 124 Stat. 1376, 1641-42 (2010).

²¹⁴ Cross-Border Security-Based Swap Activities, 78 Fed. Reg. at 30,968, 30,975 (proposed May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, 249), available at <http://www.gpo.gov/fdsys/pkg/FR-2013-05-23/pdf/2013-10835.pdf>.

²¹⁵ *Id.*

²¹⁶ *Id.*

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CFTC has stated that it will use an “outcome-based approach” as well, the CFTC will still conduct analysis of each entity-level and transaction-level requirement.²¹⁷

Another approach certain foreign regulators are taking, such as the Association of Southeast Nations Capital Markets Forum, is mutual recognition.²¹⁸ Mutual recognition is a cross-border regulatory approach where “two or more states agree to recognize the adequacy of each other’s regulation as a substitute for their own.”²¹⁹ Substituted compliance may be able to adopt many of the positive aspects of mutual recognition through the use of MOUs. By expanding the use of MOUs, the CFTC may use substituted compliance as a more limited form of mutual recognition.²²⁰

Substituted compliance is not an “all or nothing” approach, unlike mutual recognition. Substituted compliance may be determined on a rule-by-rule or institution-by-institution basis, as opposed to mutual recognition where determination will be made for countries regulatory regimes as a whole.²²¹ Under mutual recognition and the equivalence standard, there is tension created that requires a bilateral acceptance of each other’s regulatory regimes.²²² Substituted compliance allows for unilateral action, where the CFTC does not have to accept the other’s general regulatory framework.²²³ Under substituted compliance the CFTC may accept only certain aspects of the foreign regulatory regime.²²⁴ This distinction is significant, because foreign regulators may have sufficient regulations but choose to not apply their rules extraterritorially.²²⁵

VI. How Could the CFTC Improve Substituted Compliance

Although substituted compliance is the best course of action for the CFTC to take in the oversight of cross-border swaps, many aspects of the approach could be improved upon. Such a large undertaking of new regulations and oversight of cross-border swaps is a difficult task, and will require flexibility from regulators. In this Note I recommend five features that would create the most efficient regulatory environment for both businesses and the CFTC. By incorporating these recommendations, the CFTC will be able to limit the concerns of uncertainty related to the application of substituted compliance.

First, the CFTC must increase its collaboration efforts and communication among foreign regulators. The G20 goal of harmonization will not succeed if the CFTC acts as an imperialistic agency that imposes its regulations upon the entire world. For the sake of global harmonization, the CFTC must be more accommodating to different regulatory regimes. The

²¹⁷ Micah Green, et al., *Five Key Facts About the U.S. SEC’s and CFTC’s Approaches to Regulating Cross-Border Derivatives Activities*, WORLD SEC. L. REP. (Jan. 10, 2014), available at <http://www.bloomberglaw.com/document/X80GGU60000000?campaign=bnaemailink&issue=20140104&jcsearch=bna%2520a0e4e9z5q8&js=0&sitename=bna&subscriptiontype=bnawslr#jcite>.

²¹⁸ Verdier, *supra* note 206, at 57.

²¹⁹ *Id.*

²²⁰ This would appease many commentators that have found the CFTC’s approach to be to “narrow or limiting.” See Final Guidance, *supra* note 5, at 45,341; see also O’Malia Keynote Address, *supra* note 81.

²²¹ Riles, *supra* note 13.

²²² Greene & Potiha, *supra* note 19, at 370.

²²³ See *id.* at 345.

²²⁴ *Id.* at 345.

²²⁵ *Id.*

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CFTC could increase coordination between regulators through the development of minimum compliance standards that the CFTC will accept for comparability determinations.²²⁶ Minimum standards could be established either by drafting model and uniform acts or by setting baseline requirements for specific rules, which the CFTC will deem sufficient. For example, an international organization such as the Financial Stability Board (“FSB”) or other neutral bodies, could help determine whether certain entities are in compliance with international standards approved by U.S. regulators. Allowing the FSB to play a broader role will surely help in the coming years as new regulations are implemented across the world by all nations.²²⁷ Acceptance of minimum standards and assistance provided by an international organization will allow the CFTC to securely rely upon trusted foreign regulators, thereby demonstrating to global regulators the CFTC’s acknowledgement and acceptance of the autonomy of foreign regulators.

Second, the CFTC must embrace greater acceptance of differences in regulatory approaches of each sovereign jurisdiction.²²⁸ The CFTC could encourage this through the expanded use of MOUs with foreign regulators, which would increase the flexibility needed to accommodate such differences between jurisdictions.²²⁹ MOUs can be the strategic instrument used by the CFTC to bring about harmonization among global regulators.²³⁰ As opposed to other arrangements that the CFTC may use in substituted compliance determinations,²³¹ MOUs can provide reciprocal acceptance of differences in regulatory regimes. A broad application of the CFTC’s regulations upon foreign entities would foster unwarranted tension and would not be conducive to the establishment of long-term cooperation among regulators. Therefore, the CFTC can increase harmonization efforts by taking advantage of the reciprocal nature of MOUs, that allows for a more comprehensive acceptance of differences in regulatory regimes.

Third, the CFTC must create a regulatory environment in which there is certainty and confidence among market participants. The CFTC regulates a fast-paced and innovative market that has the ability to change drastically in a short period of time. It is important that the CFTC keep pace with the market and does not rely on outdated agreements and regulations. Uncertainty among market participants can be a leading source of market instability.²³² The CFTC and other regulators must limit and contain the amount of uncertainties that are a direct result of unknown regulatory factors that affect market participants. This can be accomplished by the review of comparability determinations based on terms of five years.²³³ Five-year terms would create an environment where market

²²⁶ *See id.* at 385.

²²⁷ Most nations have not yet begun implementing many of their regulations based on the goals set by the G20. The U.S. is far ahead of most regulators and governments. *See generally* FIN. STABILITY BD., OTC DERIVATIVES MARKET REFORMS, 62-69 (2013), available at http://www.financialstabilityboard.org/wp-content/uploads/r_130902b.pdf?page_moved=1.

²²⁸ Brunsden, *supra* note 43.

²²⁹ *See* O’Malia Keynote Address, *supra* note 81.

²³⁰ *See id.*

²³¹ In addition to MOUs, the CFTC may issue more limited substituted compliance determinations through CFTC No-Action and Exemptive Letters. *See id.*

²³² *See* Patrick Slovik, *Market uncertainty and Market Instability*, 43 IFC BULL. 430 (Nov. 2011), available at <http://www.bis.org/ifc/publ/ifcb34.pdf>.

²³³ Tafara & Peterson, *supra* note 193, at 56.

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participants will be able to have increased certainty in their compliance requirements for set amounts of time, while concurrently the CFTC will be able to update its regulatory policies in order to be in sync with the dynamic nature of the market. The CFTC must attempt to facilitate and increase certainty in the markets by any reasonable means available to it.

Fourth, the CFTC must address the risk culture of market participants.²³⁴ Many of the recent scandals involving financial institutions and the events triggering the financial crisis can be attributed to a weakness in the risk culture within these institutions.²³⁵ The CFTC should focus their oversight efforts on entity level requirements and allow for more flexibility on transaction level requirements. If the CFTC were to be tougher on entity related requirements it could ensure that the environment and culture of certain firms does not allow for overly risky and problematic practices. This would allow the CFTC to have more free time to address more pressing matters and pursue enforcement cases that were previously unfeasible.²³⁶ The CFTC should concentrate its limited resources on those regulations that will have an impact on the risk culture of firms, rather than those that involve individual swap transactions. It is of the upmost importance that the CFTC regulate the market by the most practicable and economical available means.

Lastly, it is critical that the process for substituted compliance determinations are as transparent as possible, in order to achieve effective global harmonization among regulators.²³⁷ Thus far the evaluation process has been “opaque and one never knows exactly how the methodology is applied.”²³⁸ A clear and transparent process would appease many market participants who have asked for a more definitive system of rules rather than the current approach taken by CFTC of issuing CFTC staff letters.²³⁹ A transparent process would assist market participants, as well as foreign regulators, in having a clear understanding of what regulatory goals the CFTC would like to see.

²³⁴ “Risk culture” does not have one generally accepted definition, however, the Institute of International Finance has defined it as “the norms and traditions of behavior of individuals and of groups within an organization that determine the way in which they identify, understand, discuss, and act on the risks the organization confronts and the risks it takes.” INST. OF INT’L FIN., REFORM IN THE FINANCIAL SERVICES INDUSTRY: STRENGTHENING PRACTICES FOR A MORE STABLE SYSTEM 31 (2009).

²³⁵ See MICHAEL POWER, SIMON ASHBY, & TOMMASO PALERMO, RISK CULTURE IN FINANCIAL ORGANISATIONS: AN INTERIM REPORT 5 (2012), available at <http://www.lse.ac.uk/researchAndExpertise/units/CARR/pdf/Risk-culture-interim-report.pdf>; see also Susan Chenyu Shaun et al., *Credit Default Swaps and Bank Risk Taking* 4 (Shanghai Advanced Inst. of Fin., Working Paper, 2014), available at <http://www.sef.hku.hk/~yjtang/ShanTangYan-CDS%20and%20Bank%20Risk%20Taking-12Jan2014.pdf>. In addition to the London Whale scandal, there was a large price fixing scandal involving the LIBOR (London Interbank Offer Rate) which resulted in Barclays paying a \$200 million CFTC fine. Press Release, Commodity Futures Trading Comm’n, CFTC Orders Barclays to pay \$200 Million Penalty for Attempted Manipulation of and False Reporting concerning LIBOR and Euribor Benchmark Interest Rates (June 27, 2012), available at <http://www.cftc.gov/PressRoom/PressReleases/pr6289-12>.

²³⁶ Dayen, *supra* note 185.

²³⁷ See O’Malia Keynote Address, *supra* note 81.

²³⁸ *Id.*

²³⁹ *Markets Seek Clarification of Cross-Border OTC Rules*, CME GROUP (Oct. 15, 2013), available at http://www.cmegroup.com/education/market-commentary/industry-news/2013/10/pre-open-industry-news_15738.html (stating “[g]iven the importance of substituted compliance determinations, the Commission should issue separate and more detailed guidance on the process by which it will make a substituted compliance determination,” in a letter co-signed by Kenneth Bentsen, president of Sifma, Walt Lukken, president and CEO of the Futures Industry Association, and Richard Whiting, executive director of The Financial Services Roundtable).

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Global harmonization among regulators is important in order to decrease competitive disadvantages brought on by stricter policies by the CFTC. Particularly for the next two years or so, U.S. firms will be at a significant competitive disadvantage because U.S. regulators are far ahead of foreign regulators at implementing regulations, so its important to make some sort of accommodation.²⁴⁰

VII. Conclusion

Although there are certain risks associated with substituted compliance, ultimately it is the best course of action for the CFTC to regulate cross-border swaps. It is very important that the CFTC strikes the proper balance in its regulatory approach, between concerns for U.S. markets (as provided for in Dodd-Frank) and the concerns of foreign regulators. Due to the CFTC's limitations, *i.e.* lack of funding and inadequate available resources, it is unable to fully regulate every swap transaction.²⁴¹ Therefore, it is important for the CFTC to regulate and use its available resources as efficiently as possible. The CFTC, like the SEC and other foreign regulators, "do not have the capacity and, figuratively speaking, is not omniscient enough to implement" regulations and watch over every transaction by itself.²⁴² "The larger the market the more difficult it is to monitor."²⁴³ Therefore, by implementing a process by which the CFTC may rely on trusted foreign regulators, the agency will be able to run as efficiently as possible.

The derivatives market is an active international market that is too difficult for one regulatory agency to monitor on its own.²⁴⁴ As such, it is critical that the CFTC rely on other regulators. Substituted compliance allows the CFTC to rely on trustworthy foreign regulators while at the same time protecting our ambitions of a more stable U.S. financial system. Substituted compliance allows for more control and flexibility than other extraterritorial regulatory approaches, such as mutual recognition and equivalence standard approach that other countries are currently implementing.²⁴⁵

Substituted compliance is a sensible approach to balance the currently unattainable G20 goal of regulatory harmonization, the unfeasible issuer-choice approach, and the extremely unrealistic approach of an imperialistic regulatory authority.²⁴⁶ Substituted compliance will not only avoid double compliance and regulatory fees for market participants,²⁴⁷ it will liberate the CFTC's limited resources because they will not have to double check the work that trusted foreign regulators have already done. The effectiveness of this regulatory approach can be further strengthened by the implementation of policies that increase transparency and rely on foreign regulators, such as those discussed above. The application of substituted compliance will be an evolving process that must adapt and learn from the fast-paced and ever-changing industry it seeks to regulate. The substituted

²⁴⁰ Jacquelyn Lumb, *Hearing Focuses on Extraterritorial Impact of Dodd-Frank Act Title VII*, SEC TODAY (Feb. 10, 2012), 2012 WL 6131766.

²⁴¹ See Dayen, *supra* note 185.

²⁴² Guseva, *supra* note 192, at 487.

²⁴³ *Id.* at 489.

²⁴⁴ *Id.*

²⁴⁵ See *supra* pt. V. C.

²⁴⁶ See *id.*

²⁴⁷ See Tafara & Peterson, *supra* note 193, at 53.

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compliance framework will provide the CFTC with the flexibility necessary to adapt to the evolving global derivatives market and achieve the necessary harmonization efforts that it requires.