United States Senate
WASHINGTON, DC 20510

July 3, 2013

Hon. Gary Gensler
Chairman
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20581

Hon. Mary Jo White
Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Dear Chairmen Gensler and White:

We are writing to urge you to finalize rules to implement the cross-border swaps provisions mandated under Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). As your agencies develop the legal framework to oversee this once unregulated market, you have the task of implementing the law in a manner that effectively protects U.S.-based financial firms, the U.S. financial system, and U.S. taxpayers from future financial crises.

The new swaps regulatory regime was deemed necessary in response to a number of high-profile, near catastrophic collapses of financial firms, arising from sometimes unknown and unquantified swaps liabilities. With the collapse of these large, international firms in mind, Congress drafted Sections 722(d) and 772(b) of the Dodd-Frank Act to ensure that U.S. regulators would protect American families and businesses from risks arising from swaps trading. The goal of the financial reforms was to prevent the need for future bailouts by allowing U.S. regulators to see, monitor, and police trading that may impact the United States. Thus, if a U.S.-based firm engages in derivatives trading activities abroad directly or through a branch or affiliate, and the risk of loss may flow back to the United States, then the law is intended to subject that trading to oversight by U.S. regulators.

Unfortunately, the current proposals to implement these much-needed reforms fail to address a large and serious risk. While the exact scope of the gap in the rules varies between your agencies' different proposals, the nature of it does not. Both of your agencies' proposals would allow U.S. firms to skirt the entire U.S.-based swaps regulatory regime (including any U.S. requirements for substituted compliance) simply by engaging in "non-guaranteed" trading through foreign subsidiaries.[1] The history of the financial crisis tells us that drawing regulatory distinctions based on narrow criteria, including over what today is believed to be "guaranteed" or not, is a recipe for creating, not reducing, systemic risk.

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[1] Some proposals also appear to permit swaps between U.S.-guaranteed foreign affiliates and certain non-U.S. persons to be outside U.S.-mandated oversight, including substituted compliance, which would be unacceptable for the same reasons outlined in this letter. Regulating "conduits" to capture these risks is necessary but insufficient.

A U.S.-based firm should not be able to escape U.S.-mandated swaps oversight simply because its swaps trading is conducted through an offshore affiliate or branch. Yet, if the current SEC and CFTC proposals are adopted, U.S. financial firms could easily arrange their affairs to produce that outcome. In considering these issues, your agencies should focus not just on the current trading marketplace, where the U.S.-parent derivatives dealer often explicitly guarantees, indemnifies, or accepts legal liability for the derivative trading activities of its offshore trading entity. Rather, your proposed rules should also take into account evolving markets, the immense market pressures on U.S. parent firms to stand behind their foreign affiliates even without explicit guarantees, and likely changes that will flow from your agencies' regulatory regimes.

It is likely that, if your agencies' current proposals were adopted, foreign firms doing business with the foreign affiliate of a U.S.-based derivatives dealer would opt to forego an explicit guarantee from the U.S.-based entity in return for: (1) more favorable pricing, and (2) the ability to avoid U.S. trading regulations and any attendant costs. If those arrangements were to become widespread, the result under your proposals as currently drafted would be to render Title VII of the Dodd-Frank Act inapplicable to that derivatives trading activity, dramatically reducing your agencies' ability to monitor and alleviate risks created by foreign trading activities that could directly and negatively impact the U.S.-based entity. At the same time, by encouraging foreign firms to do business with non-guaranteed foreign affiliates of U.S. firms in return for more favorable pricing and lighter regulatory scrutiny, your proposals would place American businesses at a competitive disadvantage to their foreign counterparts.

Even worse, because of the varied definitions of what constitutes a foreign firm, under your proposals, it appears as though foreign trading affiliates of U.S.-based derivatives dealers may be able to effectively avoid the new protections—even on trades between each other. Yet in all these circumstances, risk could quickly and easily flow back to the U.S. parent and, ultimately, the U.S. economy.

Your agencies have a statutory obligation to ensure that the liabilities of unregulated, risky foreign swaps trading truly cannot flow back to the U.S. To achieve that goal, it is important to understand the contexts in which these issues of liability would likely arise.[2]

For example, the liabilities of an offshore affiliate may come back to the U.S.-based entity if a foreign court, following foreign law, were to determine that the U.S.-based entity is liable. This type of ruling can and does happen in the context of bankruptcies. It could also happen under U.S. law, if a U.S. court were to elect to "pierce the corporate veil," and find that the U.S.-based entity is liable for the actions of its affiliate.

Another way the liabilities may come back to the U.S.-based entity is if the U.S.-based entity is placed under market pressure into effectively guaranteeing the liabilities of an offshore affiliate. As we saw during the financial crisis, several institutions bailed out legally distinct entities and investment vehicles despite having no legal obligation to do so. Protecting the firm's reputation and customer base has proven to be a powerful motivator when a U.S. parent has been asked to stand behind its affiliates.

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[2] Certainly, in some circumstances, the liability might not be found to flow to the U.S. parent. A foreign trading affiliate of a U.S.-based derivatives dealer may be viewed as a distinct legal entity by U.S. courts. A U.S. court might even issue a ruling protecting the U.S.-based entity from inheriting the legal liabilities of the foreign affiliate, absent some explicit agreement between the two. However, that type of ruling is not the only way that the foreign affiliate's liabilities may flow back to the U.S.-based entity.

This pressure to absorb liabilities of an offshore affiliate may be particularly acute if the U.S.-based entity and the foreign entity share a common name or valued customers or counterparties; if the entities have a business reliance on one another for an essential business or service; if the entities share employees or executives; or if the counterparties to the foreign entity believe that the U.S.-based entity is likely to bail out the liabilities of the foreign entity or press it to do so.[3]

We urge your agencies to revise your proposals to apply U.S. oversight and regulation to offshore affiliates and branches of U.S.-based firms whose liabilities could foreseeably flow back to the United States.[4] And while the presence of an explicit guarantee of those liabilities would be a critical (and dispositive) factor in that analysis, it is not the only relevant factor, as we noted above. Other factors that should be used to determine whether that risk is effectively guaranteed by the U.S. entity include but are not limited to whether there are:

1. limitations on the types of transactions that may occur between the U.S.-based and related foreign-based entity, including prohibitions on guarantees, indemnification agreements, liquidity puts, or any other transactions that may pass liability or losses to the U.S.-based entity, and CEO certification from both the U.S.-based entity and foreign entity regarding compliance with the restrictions;
2. specific disclosures by the U.S.-based entity to its investors and regulators that it is not guaranteeing or otherwise indemnifying the liabilities of the foreign entity;
3. specific disclosures by the foreign entity to its counterparties that it is not and cannot be guaranteed or indemnified by any other entity within the corporate family;
4. restrictions precluding the related foreign entity from operating under a common name with the U.S.-based entity, sharing common employees, executives, or directors, or sharing a common set of customers or counterparties;
5. limits on the dollar amounts of the foreign entity's trading; and
6. comprehensive resolution protocols for the foreign entity in the jurisdiction in which it is domiciled, which may include a memorandum of understanding regarding cooperation between the relevant resolution authority and the FDIC.

Finally, we remind you that it has been three years since the reforms to the swaps markets were enacted into law. Thank you for your continued efforts to implement them. Do not further delay implementing the law any longer—the risk to our economy is simply too great.

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[3] These risks are very similar to those posed to a banking entity in its relationship with private funds under the Volcker Rule. See protections put in place under sections 13(d)(1)(G) and 13(f) of the Bank Holding Company Act.
[4] If appropriate, substituted compliance may stand in for direct U.S. supervision in limited circumstances.

Sincerely,

cc: Hon. Jacob Lew
Hon. Bart Chilton
Hon. Mark Wetjen
Hon. Jill Sommers
Hon. Scott O'Malia
Hon. Elisse Walter
Hon. Luis Aguilar
Hon. Daniel Gallagher
Hon. Troy Paredes
Hon. Ben Bernanke
Hon. Dan Tarullo
Hon. Tom Curry
Hon. Martin Gruenberg