By Electronic Submission

August 28, 2023

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination Submitted on Behalf of Nonbank Swap Dealers Domiciled in the French Republic and Federal Republic of Germany and Subject to Capital and Financial Reporting Requirements of the European Union; 88 Fed. Reg. 41,774 (June 27, 2023)

Dear Mr. Kirkpatrick:

Better Markets[1] appreciates the opportunity to comment on the above-captioned proposed comparability order and request for comment ("Release" or "Proposed Order") issued by the Commodities Futures Trading Commission ("CFTC" or "Commission").[2]

This is Better Markets' third comment letter to the CFTC, stressing that comparability determinations are not merely technical exercises without serious, if not, grave consequences for customer and investor protection as well as financial stability.[3] Comparability determinations

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

[2] Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination Submitted on Behalf of Nonbank Swap Dealers Domiciled in the French Republic and the Federal Republic of Germany and Subject to Capital and Financial Reporting Requirements of the European Union; 88 Fed. Reg. 41,774 (June 27, 2023).

[3] *See* Better Markets comment letter, Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination Submitted on Behalf of Nonbank Swap Dealers Subject to Regulation by the Mexican Comision Nacional Bancaria y de Valores, (Dec. 13, 2022), https://bettermarkets.org/wp-content/uploads/2023/02/Better_Markets_Comment_Letter_Mexico_Comparability_Determination.pdf.

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outsource the protection of U.S. taxpayers, the U.S. financial system, and the U.S. economy to foreign regulations and foreign regulators (many of whom have a very poor track record of effectively enforcing even weak financial regulations). That is why comparability determinations must be robust, concrete, consistent, and based on true comparability, as required by law. That is also why the CFTC must reject the pending application and insist on compliance with U.S. standards that truly protect the American people.

In this case, a comparability determination cannot reasonably be made based on the differences in their respective provisions; the extensive array of conditions that the Commission has deemed necessary to impose; and the lack of a sufficiently detailed analysis explaining how the Commission arrived at its determination that the regulatory outcomes under the two different frameworks would be "comparable." For example, the minimum initial capital requirement for European Union nonbank swap dealers is **300%** less than the minimum capital requirement under U.S. law.

To manufacture comparability here, the CFTC hinges its finding of capital and financial reporting comparability upon a host of conditions, including but not limited to requiring the European Union swap dealers to increase their initial minimum paid-in capital by $15 million. With respect to the reporting requirements, the CFTC imposes no fewer than a dozen filing requirements that must be met as a condition for the comparability determination. This is not a comparability finding; this is de facto rewriting of the European Union's laws and rules in the form of conditions. That is also a de facto admission that the European Union regulatory regime for nonbank swap dealers is in fact not comparable.

Finally, the consequences of denying the application for a comparability order must be clearly understood. Perhaps some firms will complain that withholding a comparability determination in this instance, especially in light of the proposed conditions, and the denial of other similar petitions, represents too stringent an approach and that comparability should be interpreted more flexibly. These arguments are not consistent with the law and should not sway the Commission for at least three reasons. **First**, setting aside policy preferences, this is what the law requires: truly comparable regulatory requirements. In applying the law, comparability must be read in light of the underlying statutory purposes. In this case, that means ensuring that any foreign regime is capable of safeguarding the stability and transparency of the derivatives markets and protecting U.S. entities, U.S. markets, and the U.S. economy from the ravages of another financial crisis. The CFTC is legally bound to follow this approach. **Second**, the outcome for foreign firms is not dire. The absence of a comparability determination does not prevent them from continuing

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See also Better Markets comment letter, Notice of Proposed Order and Request for Comment on an Application for a Capital Comparability Determination from the Financial Services Agency of Japan, (October 2, 2022), https://bettermarkets.org/wp-content/uploads/2022/10/Better_Markets_Comment_Letter_Application_for_Capital-Comparability_Determination_From_the_Financial_Services_Agency_of_Japan.pdf

in business and operating how and where they see fit—provided they comply with the U.S. requirements under the Commodity Exchange Act and the Commission's rules pertaining to derivatives trading if they want access to U.S. markets. Indeed, that is also the only fair outcome because it creates a level playing field for those accessing U.S. markets and prevents regulatory arbitrage. **Finally**, in this case and many others, the compliance challenges facing firms cannot be considered unreasonable or overly burdensome for two key reasons: Congress decided that these requirements were necessary and, given that many firms seeking comparability determinations tend to be affiliates of huge banks (including the likes of Goldman Sachs, Bank of America, Citigroup, and Morgan Stanley as in the case here), U.S. domiciled affiliates that are thoroughly familiar with, and quite capable of adhering to, U.S. requirements governing derivatives activities.

INTRODUCTION

On September 24, 2021, the Institute of International Bankers, International Swaps and Derivatives Association, and Securities Industry and Financial Markets Association (together, the "Applicants") submitted an application asking for the CFTC to provide a determination that the capital and financial reporting requirements applicable to registered nonbank swap dealers organized and domiciled within the European Union (''EU'') (''EU nonbank SDs'') are comparable to the capital and financial reporting requirements applicable to nonbank SDs under the Commodities Exchange Act ("CEA").[4] More specifically, the application addresses nonbank SDs located in the French Republic (''France'') and the Federal Republic of Germany (''Germany''), the two member states of the EU in which EU nonbank SDs currently registered with the Commission are located.[5]

Such a determination would allow EU nonbank SDs to comply with the capital and reporting requirements under the CEA through compliance with the corresponding requirements under EU regulations. The determination request covers a wide range of important financial protection requirements, including those relating to regulatory objectives, qualifying and minimum capital requirements, financial reporting, and supervision and enforcement. The Commission proposes to grant the Applicants' request and issue a capital comparability determination in the form of a Commission order, subject to an extensive array of conditions.

In reaching its preliminary comparability determination, the Commission used a "principles-based, holistic approach that focuses on whether the applicable foreign jurisdiction's capital and financial reporting requirements achieve **comparable outcomes** to the corresponding CFTC requirements."[6] As a threshold matter, this approach is insufficiently rigorous, leaving far too much room for inaccurate and unwarranted comparability determinations. However, even

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4 *See* 88 Fed. Reg. at 41,774.

5 The proposed order provides that there are currently four EU nonbank SDs registered with the Commission: BofA Securities Europe SA and Goldman Sachs Paris Inc. et Cie are organized and domiciled in France; Citigroup Global Markets Europe AG and Morgan Stanley Europe SE are organized and domiciled in Germany.

6 *See* 88 Fed. Reg. at 41,775.

under this vague and inherently speculative test, it is clear that the EU nonbank SDs capital and financial reporting requirements do **not** satisfy the test for an order of substituted compliance because the EU regulatory framework governing capital and financial reporting is not comparable to U.S. requirements. As noted above, this conclusion is supported not only by differences in the countries' respective requirements but also by the CFTC's proposed imposition of numerous significant conditions that it has deemed necessary to compensate for the acknowledged gaps in the EU framework. In fact, the CFTC's proposed numerous significant conditions are a de facto admission that the regulations are not comparable and that the request should be denied.

We know from the 2008 financial crisis that the stakes are high when it comes to ensuring the financial stability of the banks and nonbanks participating in the derivatives markets. Notably at issue are the capital requirements applicable to nonbank SDs, perhaps the single most important pillar among the financial reforms adopted in the aftermath of the 2008 financial crisis. The adequacy of those capital requirements, both in the U.S. and in other countries, is critical to preventing another crisis like the one that engulfed the U.S. and the world just a decade and a half ago. In this case, the Commission cannot cede the application of U.S. law to the European Union's regime without a much more thorough, concrete, and specific demonstration of comparability.

Moreover, as stated above, this is the third time the Commission is formally applying its substituted compliance framework to the capital rules, with the application submitted by Japan on September 30, 2021, being the first, and Mexico, on September 28, 2021. As of the date of this comment letter, the Commission has not yet granted a formal order to the previous two applications. Thus, the Commission still has an opportunity to set the right precedent, faithfully follow the law, and ensure that foreign-domiciled nonbank SDs are subject to rigorous oversight and enforcement that is truly comparable to the U.S. framework.

Finally, we understand and appreciate that the CFTC has a long history of regulatory cooperation with the EU. But the financial stability stakes are especially high here, and a positive regulatory rapport with another country is no substitute for strong substantive regulation and oversight of the international and risk-laden swaps markets.

Below, we detail these issues, and we also set forth some general principles that must guide the Commission as it evaluates this request for a substituted compliance order and similar requests in the future.

BACKGROUND

The 2008 financial crisis ("2008 Financial Crisis") was catastrophic for our financial markets, our economy, and tens of millions of American families. In monetary terms, it destroyed more than $20 trillion in GDP.[7] And the human toll resulting from millions of home foreclosures,

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7 *See* Better Markets, *The Cost of the Crisis: $20 Trillion and Counting* (2015), https://www.bettermarkets.org/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis_1.pdf.

deep and prolonged unemployment and underemployment, and massive loss of wealth is incalculable, and it continues to be felt today. Moreover, on top of the damage caused by the deep recession, as much as $29 trillion was lent, spent, pledged, committed, loaned, guaranteed, and otherwise used or made available to bailout the financial system during the crisis.

One of the key factors that led to and exacerbated the crisis was regulatory arbitrage, both within the United States as between multiple financial regulatory agencies, and as most relevant here, across international borders. Foreign financial firms, including importantly foreign affiliates of U.S. financial firms, were key actors during the financial crisis, engaging in high-risk and often socially useless activities, suffering existential instability, and ultimately requiring massive bailouts at the expense of U.S. taxpayers. In fact, fully nine of the top 20 largest users of the Federal Reserve's emergency lending facilities were foreign entities. Moreover, of the top 16 beneficiaries of the AIG bailout, which paid its counterparties 100 cents on the dollar, ten were foreign.[8] Thus, weak regulation of foreign swap dealers can have dire consequences here in the U.S. This backdrop highlights the importance of the comparability determination, as this Proposed Order would apply to the European Union affiliates of Bank of American, Citigroup, Morgan Stanley, and Goldman Sachs—four systemically important institutions and among four of the top six largest recipients of taxpayer bailouts and other government rescues totaling $70 billion in TARP capital injections.[9]

The financial crisis clearly demonstrated that U.S. regulators had for too long permitted financial firms either to remain dramatically undercapitalized or to structure legal entities and activities to avoid the effective application of capital requirements. In response,[10] Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which included comprehensive and critical reforms to the oversight of the derivative markets. Specifically, Section 4s(e) mandated that SDs and major swap participants ("MSPs") meet minimum capital requirements and uncleared swap margin requirements adopted by their prudential regulator. Similarly, Section 4s(e) mandated that SDs and MSPs without a prudential regulator meet the minimum capital and uncleared swap margin requirements adopted by the CFTC.[11] The CFTC finalized its regulations imposing initial and variation margin obligations on

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[8] *See* Better Markets Comment Letter, *Prudential Standards for Large Foreign Banking Organizations; Revisions to Proposed Prudential Standards for Large Domestic Bank Holding Companies and Savings and Loan Holding Companies*, 84 Fed. Reg. 59,032 (Nov. 01, 2019).

[9] Bailout: The Rescue Plan & The Largest Recipients, N.Y. TIMES (Oct. 14, 2008).

[10] *See* Statement of Sen. Christopher Dodd, Cong. Rec., Vol. 156, Issue 104, S5828, S5832 (July 14, 2010) ("Derivatives are vitally important if utilized properly in terms of wealth creation and growing an economy. But what was once a way for companies to hedge against sudden price shocks has become a profit center in and of itself, and it can be a dangerous one as well, when dealers and other large market participants don't hold enough capital to back up their risky bets and regulators don't have information about where the risks lie"), available at https://www.congress.gov/111/crec/2010/07/14/CREC-2010-07-14-pt1-PgS5828.pdf. *See also* Statement of Sen. Carl Levin, *Id.* at S5842 ("[The Dodd-Frank Act] will bring new transparency and accountability to the shadowy market in derivatives…It empowers regulators to establish tough new capital requirements that make it harder for firms to become so big they endanger the stability of the system").

[11] 7 U.S.C. § 6s(e)(2)(B)(i) (providing that "[t]he Commission shall adopt rules for [SDs] and [MSPs], with respect to their activities as a [SD] or [MSP], for which there is not a prudential regulator imposing—capital requirements"); *see also* 7 U.S.C. § 6s(e)(1)(B) (requiring SDs and MSPs to comply with such requirements).

nonbank SDs and MSPs for uncleared swaps in 2016[12] and their regulations imposing capital requirements for nonbank SDs and MSPs in 2020.[13]

Reporting requirements were another important component of the reforms governing the swaps markets. They critically give regulators the necessary insight into the condition of market participants, allowing them to address weaknesses and problems and potentially head off potentially catastrophic failures. Section 4s(f) of the CEA mandated that all SDs and MSPs meet reporting obligations imposed by the CFTC.[14] The CFTC finalized its regulations imposing financial condition reporting requirements for SDs and MSPs in 2020 as part of the CFTC's capital requirements rulemaking mentioned earlier.[15]

COMMENTS

I. SUBSTITUTED COMPLIANCE DETERMINATIONS MUST BE MADE ONLY UPON A COMPELLING SHOWING THAT BINDING LEGAL REQUIREMENTS IN FOREIGN JURISDICTIONS ARE SUBSTANTIVELY COMPARABLE TO U.S. REQUIREMENTS AND WILL PROTECT THE U.S. FINANCIAL SYSTEM

Better Markets has repeatedly identified serious deficiencies in the "substituted compliance" approach to cross-border regulation that relies on a "regulatory outcomes" test.[16] Those deficiencies are present here, as the Commission expressly relied on the "regulatory outcomes" approach. However, although the CFTC has opted for a suboptimal framework to address cross-border issues, it can, and must, still apply that framework in a manner designed to protect the U.S. financial system as required by the letter and spirit of the law. That is, after all, the fundamental purpose of the Dodd-Frank Act. The CFTC must do this by carefully examining foreign regulatory requirements to ensure that they protect the U.S. financial system in **substance, form, as enforced, and over time.** Below we review the general principles that should guide the CFTC as it considers the current application for substituted compliance, as well as others in the future.

A. The CFTC's paramount duty under the Dodd-Frank Act is to protect the U.S. financial system.

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12 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

13 Capital Requirements of Swap Dealers and Major Swap Participants, 85 Fed. Reg. 57,462 (Sept. 15, 2020).

14 7 U.S.C.§ 6(f) (requiring all SDs and MSPs, including nonbank and bank SDs and MSPs alike to file financial condition reports).

15 Capital Requirements of Swap Dealers and Major Swap Participants, 85 Fed. Reg. 57,462 (Sept. 15, 2020).

16 *See* Better Markets Comment Letter at 25-26, Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Majority Security-Based Swaps Participants and Capital Requirements for Broker-Dealers, 83 Fed. Reg. 53,007 (Oct. 19, 2018) ("The Commission must abandon the regulatory outcomes test and must ensure that the foreign regulation is comparable in substance, form, over time, and as enforced").

Congress passed the Dodd-Frank Act to, among other things, "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' [and] to protect the American taxpayer by ending bailouts."[17] All of the CFTC's actions, including analyzing substituted compliance applications and granting substituted compliance requests, must serve and not undermine those goals. This is a critical point because far too often regulators ignore or lose sight of the fact that Congress has explicitly instructed them to protect the financial system, and they instead prioritize other goals.[18] Not only is this flawed from a policy perspective, but prioritizing other goals, such as reducing costs or burdens for the industry while ignoring or minimizing the actual goals Congress directed the CFTC to consider, is plainly unlawful.[19]

Put simply, if there is tension between the statutorily-mandated goal of protecting the American financial system on the one hand, and serving some other goal on the other hand (like comity among regulators or countries), the former must prevail. The CFTC simply cannot, as a matter of law or policy, subordinate Congress's will to other goals, no matter how important the CFTC believes those other goals may be. Accordingly, before the CFTC grants substituted compliance to reduce burdens for the industry, provide certainty, or promote international comity, it must first and foremost make a determination that granting substituted compliance complies with the law and promotes the protection of the American financial system.

This overriding policy objective applies with special force to capital requirements. In amending the CEA after the 2008 Financial Crisis pursuant to the Dodd-Frank Act, Congress gave the CFTC a clear mandate to institute capital requirements for SDs and MSPs. Section 4s(e)(3) specifies that one statutory objective of imposing capital requirements is "[t]o offset the greater risk to the [SD] and [MSP] and the financial system arising from the use of swaps that are not cleared," and in this regard, it requires capital levels that (1) "help to ensure the safety and soundness of the [SD] and [MSP];"[20] and (2) are "appropriate for the risk associated with the non-cleared swaps held as a [SD] or [MSP]."[21] Thus, any substituted compliance order issued by the CFTC in relation to a foreign jurisdiction relating to capital requirements must give special attention to this statutory mandate and objective.

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[17] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, July 21, 2010, 124 Stat 1376.

[18] *See, e.g.,* Remarks of CFTC Chairman J. Christopher Giancarlo to the ABA Derivatives and Futures Section Conference (Jan. 19, 2018) (expressing support for CFTC comparability determinations for the EU, despite differences in rules, because the determination ensures "certainty to market participants and also ensure that our global markets are not stifled by fragmentation, inefficiencies, and higher costs" without mentioning the legal requirements he and the CFTC were under or whether the comparability determination would serve to protect the U.S. financial system or serve other stated goals of the Dodd-Frank Act).

[19] *Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co*., 463 U.S. 29, 43 (1983) ("Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider").

[20] 7 U.S.C. § 6s(e)(3)(A)(i).

[21] 7 U.S.C. § 6s(e)(3)(A)(ii).

B. There must be a compelling reason to grant substituted compliance where there are material differences in binding legal requirements.

While the CFTC has unwisely rejected a more substantive, objective, and precise "line-by-line"[22] assessment or comparison in favor of a broader, ill-defined, and difficult to apply focus on "regulatory outcomes," the reality is that the best way to have confidence that a foreign jurisdiction's regulatory regime will produce substantially equivalent outcomes is to ensure that the relevant jurisdiction has substantially similar binding legal requirements. Simply put, it is difficult to imagine many cases where materially different legal requirements produce substantially similar "regulatory outcomes."

Nevertheless, if the CFTC is going to grant substituted compliance with regard to materially different regulatory requirements, the CFTC must make a well-supported, evidence-based determination that those different requirements nevertheless will, in fact, lead to comparable regulatory outcomes. At a minimum, this would require the CFTC to clearly and specifically set forth the desired regulatory outcome and provide a detailed, evidence-based explanation as to how the jurisdiction's different legal requirements nonetheless lead to that regulatory outcome.

C. The CFTC must ensure that a grant of substituted compliance remains appropriate on an ongoing basis.

A determination that a foreign jurisdiction's nonbank SDs rules would produce comparable regulatory outcomes is the beginning, not the end, of the CFTC's obligation to ensure that the activities of foreign nonbank SD entities do not pose risks to the U.S. financial system. As time goes on, regulatory requirements that, in theory, are expected to produce one regulatory outcome may, in practice, produce a different one. And, of course, the regulatory requirements may themselves be changed in a variety of ways. Finally, the effectiveness of an authority's supervision and enforcement program can become weakened for any number of reasons—the CFTC cannot assume that an enforcement program that is presently effective will continue to be effective.

Accordingly, to fulfill its statutory obligation to protect the U.S. financial system, the CFTC must ensure, on an ongoing basis, that each grant of substituted compliance remains appropriate over time. At the very least, this would require that each order granting substituted compliance, and each memorandum of understanding with a foreign regulatory authority, impose an obligation that the applicant, as appropriate:

(1) Periodically apprise the CFTC of the activities and results of its supervision and enforcement programs, to ensure that they remain sufficiently robust to deter and address violations of the law; and

[22] *See* 88 Fed. Reg. 41,775.

(2) To immediately apprise the CFTC of any material changes to the regulatory regime, whether explicit (i.e., rule changes) or implicit (i.e., changes in how a rule is interpreted, applied, or enforced).

II. NEITHER THE EUROPEAN UNION'S CAPITAL REQUIREMENTS NOR THE FINANCIAL REPORTING REQUIREMENTS ARE COMPARABLE TO THE CORRESPONDING U.S. REQUIREMENTS.

The Proposed Order does not provide adequate support for a determination of comparability between the U.S. and EU capital and financial reporting regimes. In fact, based on the application, the capital and financial reporting requirements in the EU do **not** appear comparable to those under the CEA, for at least three reasons. First, the requirements on their face are different. Second, the nature and number of the conditions that the Commission deemed necessary to impose are inconsistent with a finding of comparability. Finally, the Proposed Order fails to provide sufficient analysis as to exactly how and why the Commission concluded that the European Union and American frameworks would produce "comparable outcomes." It relies too much on conclusionary statements that the two regimes are comparable without disclosing sufficient facts, data, or analysis to support its findings. Such an inherently difficult and predictive analysis of likely outcomes requires a more thorough explanation than that offered in the Proposed Order.

A. The capital requirements are not comparable.

As the Proposed Order notes, the capital requirements for EU nonbank SDs are significantly different from those adopted by the CFTC for U.S. nonbank SD entities. While the CFTC's Bank-Based Capital Approach and the EU's capital rules for nonbank SDs are both based on the Basel framework for bank capital, there are important differences. These differences are manifested in the distinct definitions of capital adopted by the two regulatory regimes, as well as their different approaches to ensuring adequate levels of capital based on risk.

The Proposed Order relies in part on the fact that the CFTC and EU capital requirements for nonbank SDs are both consistent with the Basel framework. By way of explanation, the CFTC capital rules for nonbank SDs allow for three separate capital approaches: the Tangible Net Worth Approach, the Net Liquid Assets Capital Approach, or the Bank-Based Capital Approach.[23] The Bank-Based Capital Approach is based on capital requirements set by the Federal Reserve Board of Governors for bank holding companies and is also consistent with the international framework for capital developed by the Basel Committee on Banking Supervision ("Basel").[24] For purposes of analyzing the EU's capital requirements for EU nonbank SDs, the CFTC compares the EU regulatory regime with the CFTC's Bank-Based Capital Approach because the EU requirements

[23] 17 CFR 23.101.
[24] *See* Fed. Reg. 88 at 41,781.

are also based on the Basel framework, and EU nonbank SDs are "subject to the current bank-based capital approach of the EU capital rules."[25]

However, the Proposed Order rightly notes that just because a foreign jurisdiction's regulatory regime is "consistent" with the Basel framework, it does not follow that it is "comparable" to the CFTC capital rules "without an assessment of the individual elements of the foreign jurisdiction's capital framework."[26] Therefore, the CFTC correctly concludes that an assessment of each individual element of the foreign jurisdiction's capital framework is necessary before a determination of comparability between the CFTC's capital rules and the EU's capital rules can be made. Below, we have highlighted in more detail individual elements of the EU's capital rules that differ from the CFTC's capital rules. More analysis is needed The CFTC needs to provide more analysis is needed by the CFTC to ascertain the comparability of capital between the two sets of rules.

While it is true that the EU regime may have certain strengths, those pieces cannot substitute for the whole. For example, the EU capital rules require its nonbank SDs to maintain a capital conservation buffer composed exclusively of common equity tier 1 capital in an amount equal to 2.5 percent of the firm's total risk-weighted assets.[27] Also, the EU capital rules call for liquidity requirements on EU nonbank SDs. The liquidity requirements require EU nonbank SDs to hold an amount of sufficiently liquid assets to meet expected payment obligations under stressed conditions for 30 days.[28]

Nevertheless, the differences in the two capital frameworks stand as an obstacle to a comparability determination. A well-known, longstanding foundational principle of capital regulation reflected in the law requires both the quantity **and** quality of capital to meet minimum criteria. If either is missing or inadequate, then the regimes cannot be comparable. The EU and U.S. capital frameworks are different on both counts, quantity, and quality.

Capital in Relation to Uncleared Swap Margin Amount

For example, the qualifying regulatory capital to cover operational risks for EU nonbank SDs is not comparable to the CFTC's requirement of qualifying capital in an amount equal to at least 8 percent of the nonbank SD's uncleared swap margin amount. The Proposed Order claims that the EU capital rules impose capital and liquidity requirements that may compensate for the lack of direct comparison to the 8 percent uncleared swap margin requirement. For example, the EU capital rules require that EU nonbank SDs calculate capital charges for operational risk as a separate component of the total risk exposure amount.[29] Moreover, the EU capital rules impose

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[25] *See* Fed. Reg. 88 at 41,784.
[26] *See* Fed. Reg. 88 at 41,785.
[27] *See* Fed. Reg. 88 at 41,782.
[28] *See* Fed. Reg. 88 at 41,793.
[29] *See* Fed. Reg. 88 at 41,795.

separate liquidity requirements designed so that the EU nonbank SDs can meet short- and long-term obligations.[30]

Nevertheless, the CFTC falls short in furnishing an exhaustive analysis substantiating that the incorporation of an operational risk charge and the existence of separate liquidity requirements will genuinely yield an equivalent result. Moreover, if the CFTC places its faith in the concept of "comparable outcomes," it should have undertaken an examination to ascertain whether the EU nonbank SD's operational risk charge and liquidity requirements capital would adequately cover their cumulative amounts of uncleared swaps margin. Thus, the EU approach, as set forth in the proposal, is not comparable to the CFTC capital rules.

Minimum Capital

Another major difference in the EU capital rules relative to the CFTC rules is that the EU framework establishes a substantially lower dollar minimum capital requirement. One of the elements of the CFTC Bank-Based Capital Approach is that nonbank SDs must maintain "an amount of common equity tier 1 capital of at least $20 million."[31] In stark contrast, the EU requires its nonbank SDs to comply with a **minimum initial capital requirement of EUR 5 million of common equity tier 1 capital**.[32] This, on its face, demonstrates a fatal lack of comparability. To compensate for this gap, one of the conditions set forth in the Proposed Order is for EU nonbank SDs to "maintain a minimum level of fundamental capital" of at least $20 million.[33]

Failure to Support a "Comparable" Outcomes Determination

As noted above, the Commission has adopted a flawed approach to making comparability determinations, rejecting a careful, provision-by-provision comparison in favor of a vague and difficult to apply "comparable outcomes" approach. It is an exceedingly difficult test to administer reliably, in part because it calls upon the CFTC to make predictions about the eventual impact of two different sets of regulatory requirements. To apply such a test, the Commission would have to articulate how it goes about making such predictions as a general matter and then apply that test in each case. Here, the Commission has done neither, instead making conclusory assertions, without a disclosed basis or sufficient analysis, that notwithstanding differences in the capital requirement, the two frameworks are expected to yield comparable outcomes. This is not an acceptable approach that complies with the law to achieve the policy objectives.

In short, the foregoing analysis illustrates two related problems with the Commission's comparability analysis: The CFTC's and EU's approaches to nonbank SD capital requirements differ in material respects, and the Proposed Order fails adequately to explain how the CFTC justifies its conclusion that they are comparable notwithstanding these material differences.

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[30] *Id.*
[31] *See* Fed. Reg. 88 at 41,788.
[32] *See* Fed. Reg. 88 at 41,793.
[33] *See* Fed. Reg. 88 at 41,808.

B. The financial reporting requirements are not comparable.

Similar problems are reflected in the comparability analysis for the reporting requirements. Despite a number of material differences highlighted in the Proposed Order between the U.S. and the EU reporting requirements for nonbank SDs, the CFTC preliminarily determines that the reporting requirements are comparable, again subject to conditions.

Yet the sheer number and variety of conditions regarding financial reporting are the most compelling evidence that the requirements are not in fact comparable. The Proposed Order sets forth no fewer than a dozen filing requirements that must be met as a condition for the comparability determination. Some of them are understandable requirements that the banks must provide **copies** of items already required to be filed under the EU requirements. But others relate to regulatory filings that are apparently not currently required at all under the EU and therefore represent gaps in the EU regime. Among those are the filing of the aggregate securities, commodities, and swap positions information set forth in Schedule 1 of Appendix B (items 11); a statement confirming the truth of various filings (item 14); a margin report (item 15); a notice of noncompliance (item 16); a notice of insufficient regulatory capital (item 17); and notice of a long list of occurrences (item 23).

Compounding these deficiencies, some of the CFTC's conditions are seriously flawed, and even if the conditions were satisfied, the regimes would not be comparable. For example, as noted above, one condition requires that EU nonbank SDs submit a statement—**not** an oath or affirmation as required of U.S. nonbank SDs—from an authorized representative of the company that to the best knowledge and belief of the persons(s) the information contained in the respective report is true and correct.[34] As is well-known, there are material legal differences between submitting a "statement" as EU nonbank SDs would have to do under this condition and the existing requirement for U.S. nonbank SDs that must submit an oath or affirmation. The Proposed Order fails to address, explain, or explore this explicit and very significant difference.

While the CFTC proposes an extensive array of conditions on the determination of comparability with respect to reporting obligations, it takes a hands-off approach to the review of risk models and related reporting. The Proposed Order provides that the CFTC does not need to review, monitor, or approve the internal models used by EU nonbank SDs to measure risk exposure. Moreover, the Release specifically states that "[t]he Commission is not proposing to require that an EU nonbank SD that have been approved by the EU to use capital models to file monthly model metric information contained in Regulation 23.105(k)."[35] While the U.S. allows nonbank SDs to utilize internal models to calculate risk exposure, the CFTC must approve the use of such internal models. Thus, with respect to the internal models used by EU nonbank SDs to measure their risk exposures, the CFTC is proposing to take a back seat to the EU and blindly

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34 *See* Fed. Reg. 88 at 41,796.

35 *See* Fed. Reg. 88 at 41,801.

accept the assessments resulting from their use of internal models to calculate risk.[36] This lack of a condition regarding risk models undercuts the notion that the two reporting and risk assessment regimes could be regarded as comparable even with the provisos set forth in the Proposed Order. At a minimum, the Proposed Order should be amended to require the submission by the EU nonbank SDs of risk model metric information to the CFTC.

III. THE COMMISSION'S RELIANCE ON AN EXTENSIVE ARRAY OF CONDITIONS INCLUDED IN THE PROPOSED ORDER IS ESPECIALLY PROBLEMATIC, IN BOTH THEORY AND PRACTICE.

The differences between the capital and financial reporting regimes applicable to nonbank SDs in the EU and the U.S., explained above, warrant the denial of the Applicants' request for a comparability determination. However, instead of simply denying substituted compliance as the law requires, the CFTC proposes to establish a set of conditions presumably intended to ensure that the two regimes **become** comparable. This is nothing less than a concession that the two regimes are not comparable. It furthermore raises the question of why substituted compliance is being granted if the CFTC has determined that numerous material conditions are required to make a comparability determination. Granting substituted compliance with multiple material conditions intended to replicate the CFTC's capital and reporting requirements undermines the statutory policy and requirement of substituted compliance in the first place—protecting the stability of the U.S. financial system by allowing substituted compliance **only when** foreign regimes are comparable.

While imposing certain (non-material) conditions may be appropriate, the CFTC has not provided any principled basis for differentiating between a minimal use of conditions to refine what are fundamentally comparable regulatory regimes, on the one hand, and the use of multiple substantive conditions in an attempt to force fit what are in fact very different—i.e., non-comparable—regimes, on the other hand.

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[36] The failure of internal risk models was one of the key failings identified in the aftermath of the 2008 Financial Crash, which is why there are approval requirements like the one imposed by the CFTC here. *See* Financial Crisis Inquiry Commission Report 65 (2011) ("Because investment banks were not subject to the same capital requirements as commercial and retail banks, they were given greater latitude to rely on their internal risk models in determining capital requirements, and they reported higher leverage. At Goldman Sachs, leverage increased from 17:1 in 2000 to 32:1 in 2007. Morgan Stanley and Lehman increased about 67% and 22%, respectively, and both reached 40:1 by the end of 2007); *see also* Richard Spillenkothen, *Notes on the performance of prudential supervision in the years preceding the financial crisis by a former director of banking supervision and regulation at the Federal Reserve Board* (1991 to 2006) 12, (May 31, 2010) ("major regulatory and supervisory policy mistakes included…[a]cceptance of Basel II premises…comprising an excessive faith in internal bank risk models, an infatuation with the specious accuracy of complex quantitative risk management techniques, and a willingness (at lease in the early days of Basel II) to tolerate a reduction in regulatory capital in return for the prospect of better risk management and greater risk-sensitivity").

The approach is flawed on a practical level as well. Essentially, the CFTC is adding an entire layer of another set of capital and reporting requirements that EU nonbank SDs will have to abide by in addition to the EU laws and rules. At best, this will exacerbate complexity, as the CFTC will have to monitor compliance with all of the conditions, including reviewing the financial reports of the EU nonbank SDs and tracking developments in the EU regulatory regime more generally.

This in turn raises the concern that the CFTC may in the future be inclined to drop or dilute some of the requirements rather than rescind the grant of substituted compliance if the CFTC and the EU are met with resistance from firms in the EU facing the associated compliance costs and burdens. For this reason, as well, the CFTC should simply deny the petition for a comparability order and apply the full array of U.S. requirements to EU nonbank SDs. The burden would then fall on the EU, as it should, to raise its standards governing nonbank SDs activities, so that the requirements and outcomes under its regime are truly comparable to those produced under U.S. law.

Finally, we emphasize that if the CFTC proceeds to finalize the comparability order notwithstanding the law and the underlying policy objectives, then it must at least ensure that the conditions are robustly maintained and enforced. These conditions, supplemented as argued above, are more than mere enhancements or adjustments to an otherwise comparable regime; they are essential, the **bare minimum** that the CFTC must establish, that EU nonbank SDs must follow.

The CFTC **absolutely must not weaken or eliminate these essential conditions** in response to comments by the industry, which is primarily concerned with reducing its own operational costs without adequate regard for the systemic risk that doing so would pose. Any determination to find the EU's capital rules comparable to the CFTC's capital rules without conditions at least as strong as proposed (and enhanced) would not only contravene the agency's own conception of substituted compliance but expose the U.S. financial system to the very risks the Dodd-Frank Act instructed the CFTC to contain.

CONCLUSION

We hope these comments are helpful as the Commission finalizes its response to the Applicants' request for a comparability determination.

Sincerely,

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