<u>By Electronic Submission</u>

March 24, 2024

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 Subject to Capital and Financial Reporting Requirements of the United Kingdom and Regulated by the United Kingdom Prudential Regulation Authority; 89 Fed. Reg. 8026 (February 5, 2024)

Dear Mr. Kirkpatrick:

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

The importance of the CFTC's responsibility and duty to undertake robust comparability determinations cannot be overstated. These determinations de facto outsource the protection of U.S. taxpayers, its financial system, and its economy to foreign governments, laws, regulations, regulators, and supervisors. Given that most of them have failed miserably and repeatedly in the past to protect their own taxpayers, citizens, financial systems, and economies – to catastrophic effect in 2008 - the stakes for the U.S. in such determinations are extremely high. [3]

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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 Subject to Capital and Financial Reporting Requirements of the United Kingdom and Regulated by the United Kingdom Prudential Regulation Authority; 89 Fed. Reg. 8026 (February 5, 2024).

3 Better Markets has engaged extensively with the CFTC on cross-border issues generally since 2011.

As you know, the unregulated derivative markets invisibly incubated and ignited the devastating 2008 crash. Derivatives acted as a conveyor belt to transmit the financial crisis around the globe, causing a cataclysmic feedback loop that first undermined global financial institutions, then entire financial systems, and, finally, the economies of the U.S. and the world.

That derivatives conveyor belt was greased by a global race to the regulatory bottom in the years before the crash, where countries competed with each other to lure financial firms with promises of so-called "light touch" regulation, which often was actually no regulation, supervision, oversight, or enforcement. In the years before 2008, the United Kingdom ("UK") "won" that race as many, if not most, of the global derivatives dealers located their operations in London, including Lehman Brothers, AIG, and others. As a result, London's financial district got the jobs, tax revenue, and prestige from being a global center of finance, albeit largely unregulated, until London and the world lost it all and much more when it all blew up in the 2008 crash.

That open and blatant regulatory arbitrage grievously harmed the UK's citizens, taxpayers, banking and financial systems, economy, and treasury. For example, as of 2011, the cost of the UK's nationalization of five dealer banks was more than 1.15 trillion pounds. The UK's entire GDP in 2008 was just 1.4 trillion pounds. Better Markets discussed this in greater detail in a presentation to the CFTC in 2013.[4] Remarkably, as of today – 15 ½ years later – the UK government – meaning UK taxpayers – still owns 35% of NatWest Group (down from 84% when the bank was nationalized in 2008).

While banks in the U.S. were not formally nationalized, the damage in the U.S. was just as bad, if not worse. Virtually every American was impacted by the 2008 crash. Tens of millions of Americans were thrown out of work and lost their homes, life savings, educations, retirements, standards of living, sense of security, and so much more – in many respects, the country suffered a lost generation due to that crash. While dollars fail to capture the depth and breadth of that devastation, that crash cost the U.S. tens of trillions of dollars.

Obviously, derivatives were not alone responsible for all of that, but the derivatives markets, the cross-border activities of derivatives dealers, and global regulatory arbitrage were unquestionably key drivers of the crash. That's why ***<u>the CFTC in the Dodd-Frank Act was given the power, authority, mandate, and duty to properly regulate derivatives</u>*** and to do its part to make sure that the American people were never again victimized by un- and underregulated derivatives markets in the U.S. ***<u>and</u>*** globally. It was specifically empowered and directed to ensure that a global race to the regulatory bottom and regulatory arbitrage did not undermine U.S.

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*See, e.g.,* Better Markets' "Cross-Border Regulations Protecting The Financial System From Overseas Risk," listing a decade of advocacy activities, available at https://bettermarkets.org/newsroom/cross-border-regulations-protecting-financial-system-overseas-risk/. This letter is Better Markets' fourth recent comment letter to the CFTC on its pending comparability proposals. *See, infra*, n. 12.

4 *See* Better Markets' summary presentation, *Cross-Border Derivatives Regulation* (June 21, 2013), available at https://bettermarkets.org/sites/default/files/CFTC%20Cross-border-%206-21-13.pdf.

derivatives laws and regulations. That's where cross-border regulation and comparability mandates are applicable.

***The CFTC was given this critical responsibility*** because other countries to varying degrees have a conflict of interest in enforcing effective rules on foreign financial firms operating in their country, including derivatives dealers. Weak or ineffective regulation will attract financial firms and high paying jobs with the associated substantial tax revenue, not to mention cachet and bragging rights, which current politicians might overweight against the risk of a future financial crash that happens on someone else's watch (or if they calculate that someone else – like the U.S. – will end up paying for most of the damage done by the next crash).

This isn't limited to the years before the 2008 crash, just a matter of history, or speculation and conjecture about the future. While much has admittedly changed since the 2008 crash, history is repeating itself as the UK tries to dig itself out of the mess it created by Brexit and, in particular, its desperate attempt to restore London to its status as a global financial center given that self-inflicted wound forced much of finance to relocate to the EU. Both major UK parties are currently preparing for elections and trying to outbid each other (pun intended) in claiming to "unashamedly champion" London's financial sector. Sure, this is phrased in polite language and euphemisms like "competitiveness," but make no mistake about it: this is little more than the old promise of light-touch regulation and incentivizing regulatory arbitrage.

Because the CFTC's comparability determinations de facto outsource the protection of U.S. taxpayers and the stability of its financial system and economy to foreign governments and regulators, ***the law requires the CFTC*** to ensure that such determinations are robust in form, substance, enforcement, and over time. It must be comparability, in fact, not artificially constructed after the fact. Here, the request clearly fails on all counts. ***Frankly, the sheer number and variety of conditions the CFTC seeks to impose here regarding financial reporting are compelling evidence - and a de facto admission - that the requirements are not in fact comparable.***

Specifically, a comparability determination cannot reasonably be made here due to the many material differences in their respective provisions; the extensive array of conditions that the CFTC has deemed necessary to impose; and the lack of a sufficiently detailed analysis explaining how the CFTC arrived at its determination that the regulatory outcomes under the two different frameworks would – or could - be "comparable." ***This is not a comparability analysis. This is the CFTC making lots of unsupported assertions as if that is an analysis when it is not.***

To manufacture comparability here, the CFTC is basically rewriting UK law by hinging its finding of capital and financial reporting comparability upon a host of conditions. For example, the minimum initial capital requirement for nonbank swap dealers in the United States is **2000%** more than the minimum capital requirement for nonbank swap dealers in the UK under the Prudential Regulation Authority ("PRA").[5] To remedy this non-comparability, the CFTC is

[5] The UK PRA Capital Rule requires a minimum of GBP 750,000 which converts to approximately $950,5000. The CFTC requires a minimum of $20 million.

requiring the nonbank swap dealers ("SDs") in the UK to increase their initial minimum paid-in capital by $19 million to hit the minimum threshold of $20 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 a de facto rewriting of the PRA's laws and rules in the form of conditions. That is also ***a de facto admission that the United Kingdon's 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, represents too stringent an approach and that comparability should be interpreted more flexibly. These arguments have no merit and are not consistent with the law and should not influence the CFTC 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 determined based on the law and 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 has been charged with this duty and 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 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 CFTC'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, as they already do every day all day.

## INTRODUCTION

On May 4, 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 UK, which are licensed as investment firms designated for prudential supervision by the PRA ("PRA-designated UK nonbank SDs"), are comparable to the capital and financial reporting requirements applicable to nonbank SDs under the Commodities Exchange Act ("CEA").[6]

Currently, there are six PRA-designated UK nonbank SDs registered with the CFTC:.

1. Citigroup Global Markets Limited,
2. Goldman Sachs International,
3. Merrill Lynch International,
4. Morgan Stanley & Co. International Plc,
5. MUFG Securities EMEA Plc, and
6. Nomura International Plc.

Such a determination would allow PRA-designated UK nonbank SDs to comply with the capital and reporting requirements under the CEA through compliance with the corresponding requirements under UK PRA 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 CFTC proposes to grant the Applicants' request and issue a capital comparability determination in the form of a CFTC order, subject to an extensive array of conditions.

In reaching its preliminary comparability determination, the CFTC 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."[7] As a threshold matter, this approach is insufficiently rigorous, leaving far too much room for inaccurate and unwarranted comparability determinations. However, even under this vague and inherently speculative test, it is clear that the PRA-designated UK nonbank SDs capital and financial reporting requirements do **not** satisfy the test for an order of substituted compliance because the UK PRA 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 country's 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 UK PRA 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.

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6 *See* 89 Fed. Reg. at 8026. The Proposed Order notes that the Applicants also requested a comparability determination for nonbank SDs licensed as investment firms and prudentially regulated by the UK Financial Conduct Authority ("FCA"). The Commission stated that it anticipates assessing the comparability of the rules applicable to FCA-regulated UK nonbank SDs through a separate capital comparability determination.

7 *See* 89 Fed. Reg. at 8027.

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 CFTC cannot cede the application of U.S. law to the United Kingdom's regime without a much more thorough, concrete, and specific demonstration of comparability. Among other examples demonstrating the need for this, the 2012 London Whale incident, where a trader at JPMorgan Chase's London office incurred losses exceeding $6 billion due to oversized positions in the credit derivatives market, should continuously serve as a reminder.[8]

Moreover, this is the fourth time the CFTC is formally applying its substituted compliance framework to the capital rules, with the proposed order issued by the CFTC for Japan on August 8, 2022, for Mexico on December 13, 2022, and for the European Union, specifically Germany and France, on June 27, 2023.[9] As of the date of this comment letter, the CFTC has not yet granted a formal order to the previous three applications. Thus, the CFTC 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. That is what the law requires the CFTC to do and why Congress and the President in the Dodd-Frank Act gave the CFTC this very important and highly consequential duty.

Finally, we understand and appreciate that the CFTC has a long history of regulatory cooperation with the United Kingdom as well as the desire for international cooperation and comity more broadly. But the financial stability stakes are especially high here, and a desire for regulatory rapport with another country is no substitute for strong substantive regulation and oversight of the international and risk-laden derivatives markets.

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[8] Patricia Hurtado, *The London Whale*, Bloomberg (April 23, 2015), *available at* *https://www.bloomberg.com/opinion/quicktake/the-london-whale?terminal=true&sref=mQvUqJZj*

[9] *See* 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 7, 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. *See also* 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. *See also* 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 Domiciled in the French Republic and Federal Republic of Germany and Subject to Capital and Financial Reporting Requirements of the European Union, (August 28, 2023), https://bettermarkets.org/wpcontent/uploads/2023/08/Better_Markets_Comment_Letter_Capital_Comparability_Determination.pdf.

**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.[10] The human toll resulting from millions of home foreclosures, 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.[11]

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. and global 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.[12] 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 United Kingdom 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 alone.[13]

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, among others. In response,[14]

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[10] *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.

[11] *See* L. Randall Wray, *$29,000,000,000,000: A Detailed Look at the Fed's Bailout of the Financial System*, Levy Economics Institute of Bard College (December 12, 2011), available at https://www.levyinstitute.org/pubs/op_23.pdf

[12] *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).

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

[14] *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*

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.[15] The CFTC finalized its regulations imposing initial and variation margin obligations on nonbank SDs and MSPs for uncleared swaps in 2016[16] and their regulations imposing capital requirements for nonbank SDs and MSPs in 2020.[17]

Reporting requirements were another important component of the reforms governing the derivatives 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.[18] 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.[19]

## 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 CFTC's "substituted compliance" approach to cross-border regulation that relies on a "regulatory outcomes" test.[20]

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*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").

[15] 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).

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

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

[18] 7 U.S.C.§ 6(f) (requiring all SDs and MSPs, including nonbank and bank SDs and MSPs alike to file financial condition reports).

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

[20] *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").

Those deficiencies are present here, as the CFTC 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 law is to protect the U.S. financial system.

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."[21] 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.[22] 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.[23]

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 protects the American financial system.

This overriding legally required policy objective applies with special force to capital requirements. In amending the CEA after the 2008 Financial Crisis pursuant to the Dodd-Frank

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

22 *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).

23 *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").

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];"[24] and (2) are "appropriate for the risk associated with the non-cleared swaps held as a [SD] or [MSP]."[25] 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.

### 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"[26] 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 it believes is presently effective will continue to be effective.

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[24] 7 U.S.C. § 6s(e)(3)(A)(i).
[25] 7 U.S.C. § 6s(e)(3)(A)(ii).
[26] *See* 89 Fed. Reg. 8027.

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

(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 UK PRA'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 UK PRA capital and financial reporting regimes. In fact, based on the application, the capital and financial reporting requirements in the UK PRA 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 CFTC deemed necessary to impose are inconsistent with a finding of comparability.

**Third**, the Proposed Order fails to provide sufficient analysis as to exactly how and why the CFTC concluded that the United Kingdom 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 PRA-designated UK 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 UK PRA'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 UK PRA 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.[27] 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").[28] For purposes of analyzing the UK PRA's capital requirements for PRA-designated UK nonbank SDs, the CFTC compares the UK PRA's regulatory regime with the CFTC's Bank-Based Capital Approach because the UK PRA requirements are also based on the Basel framework, and PRA-designated UK nonbank SDs are "subject to the current bank-based capital approach of the UK PRA capital rules."[29]

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."[30] 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 UK PRA's capital rules can be made. Below, we have highlighted in more detail individual elements of the UK PRA's capital rules that differ from the CFTC's capital rules. Nevertheless, 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 UK PRA regime may have certain strengths, those ***pieces cannot substitute for the whole***. For example, PRA-designated UK nonbank SDs must hold total regulatory capital of at least 10.5 percent of their total risk exposure, including market, credit, CVA, settlement, and operational risks. This consists of an 8 percent base requirement plus a 2.5 percent capital conservation buffer, exceeding the 8 percent minimum mandated for nonbank SDs under the CFTC Capital Rules.[31] Also, the UK PRA capital rules call for liquidity requirements on PRA-designated UK nonbank. The liquidity requirements require the PRA-designated UK nonbank to hold an amount of sufficiently liquid assets to meet expected payment obligations under stressed conditions for 30 days.[32]

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 UK PRA and U.S. capital frameworks are different on both counts, quantity and quality.

27 17 CFR 23.101.
28 *See* Fed. Reg. 89 at 8032.
29 *See* Fed. Reg. 89 at 8035.
30 *See* Fed. Reg. 89 at 8036.
31 *See* Fed. Reg. 89 at 8046.
32 *See* Fed. Reg. 89 at 8045.

Capital in Relation to Uncleared Swap Margin Amount

For example, the qualifying regulatory capital to cover operational risks for PRA-designated UK 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 UK PRA capital rules impose capital and liquidity requirements that may compensate for the lack of direct comparison to the 8 percent uncleared swap margin requirement.[33] Moreover, the UK PRA capital rules require that PRA-designated UK nonbank SDs calculate capital charges for operational risk as a separate component of the total risk exposure amount.[34] As a result, the CFTC believes that the inclusion of an operational risk charge in the PRA-designated UK nonbank SD's total risk exposure and the existence of separate liquidity requirements will achieve a comparable outcome.[35]

Despite the CFTC's conclusory analysis, the Proposed Order falls short in furnishing an adequate 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 is going to place its faith in the concept of "comparable outcomes," it should have undertaken an examination to ascertain whether the PRA-designated UK nonbank SD's operational risk charge and liquidity requirements would adequately cover their cumulative amounts of uncleared swaps margin. Thus, the UK PRA approach, as set forth in the proposal, is not comparable to the CFTC capital rules.

Minimum Capital

Another major difference in the UK PRA capital rules relative to the CFTC rules is that the PRA 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."[36] In stark contrast, the PRA requires its nonbank SDs to comply with a minimum initial capital requirement of GBD 750,000 of base capital requirement.[37] **This, on its face, demonstrates a fatal lack of comparability**. To compensate for this gigantic gap, one of the conditions set forth in the Proposed Order is for PRA-designated UK nonbank SDs to "maintain a minimum level of common equity tier 1 capital" of at least $20 million.[38]

Failure to Support a "Comparable" Outcomes Determination

[33] *See* Fed. Reg. 89 at 8047.
[34] *Id*.
[35] *Id*.
[36] *See* Fed. Reg. 89 at 8039.
[37] *See* Fed. Reg. 89 at 8045.
[38] *Id*.

As noted above, the CFTC 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 CFTC must articulate how it goes about making such predictions as a general matter and then apply that test in each case. Here, the CFTC has done neither, instead making conclusory assertions - without a disclosed basis or sufficient analysis - that notwithstanding clearly material differences in the capital requirement, the two frameworks are expected to yield comparable outcomes. ***This is mere assertion, not analysis.*** That is plainly inadequate given the importance and gravity of these requirements. This approach fails to comply with the law and will not achieve the critically important policy objectives.

In short, the foregoing discussion illustrates two related problems with the CFTC's so-called comparability analysis: The CFTC's and UK PRA'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.

**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 UK PRA 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 UK PRA requirements. But others relate to regulatory filings that are apparently not currently required at all under the UK PRA and therefore represent gaps in the regime. Among those are the filing of the aggregate securities, commodities, and swap positions information set forth in Schedule 1 of Appendix B (items 12); a margin report (item 14); a notice of noncompliance (item 15); a notice of insufficient regulatory capital (item 16); and notice of a long list of occurrences (item 22).

While the CFTC proposes an extensive array of conditions on the determination of comparability with respect to reporting obligations, it inexplicably and dangerously 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 PRA-designated UK nonbank SDs to measure risk exposure. Moreover, the Proposed Order specifically states that "[t]he Commission is not proposing to require that a PRA-designated UK nonbank SDs that have been approved by the PRA to use capital models to file monthly model metric

information contained in Regulation 23.105(k).”[39] 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 PRA-designated UK nonbank SDs to measure their risk exposures, the CFTC is proposing to take a back seat to the UK and ***blindly accept*** the assessments resulting from their use of internal models to calculate risk.[40] 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.

## III. THE CFTC’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 PRA-designated UK nonbank SDs and the U.S., detailed above, compel 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 arguably **become** comparable. Not only is this not what the law requires, it is nothing less than a de facto admission 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 violates and undermines the law and policy 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 in fact 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

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39 *See* Fed. Reg. 89 at 8052.

40 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”).

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.

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 PRA-designated UK nonbank SDs will have to abide by in addition to the UK PRA 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 PRA-designated UK nonbank SDs and tracking developments in the UK PRA regulatory regime more generally.

Even if the CFTC somehow finds the time, resources, and will to do all of this, it nonetheless 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 UK PRA are met with resistance from firms in the UK and face the inevitable claims of undue 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 PRA-designated UK nonbank SDs. The burden would then fall on the UK PRA, as it should, to raise its standards governing nonbank SDs activities, so that the requirements and outcomes under its regime are in fact comparable to those produced under U.S. law.

After all, these swap dealers are GSIBs and too big to fail. As they learned in 2008 and thereafter, externalizing their costs is lucrative to them and they won't pay a price for that because they will get bailed out when financial instability materializes. They will once again privatize profits and socialize losses. Eliminating that is precisely why the law mandates that the CFTC make robust comparability determinations that in fact protect the American people, the U.S. financial system, and the economy. Any determination to find the UK PRA'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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