SHADOW FINANCIAL REGULATORY COMMITTEE

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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Co-Chair
Loyola University Chicago

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Statement No. 358

Edward J. Kane
(520)-299-5066

Franklin Edwards
(917)-921-4050

Statement of the Shadow Financial Regulatory Committee on

Regulating Cross-Border Swaps Transactions of US Banking Affiliates

September 21, 2015

A major objective of the derivatives provisions in the Dodd-Frank Act is to reduce the likelihood that losses incurred by US banks and other US derivatives market participants might require another US bailout to preserve financial stability. Currently, non-US affiliates of major US banking organizations have found a way to escape US regulatory oversight of their swaps transactions. To close this loophole, the Shadow Financial Committee believes it is important that the Commodity Futures Trading Commission (CFTC) exercise authority over non-US derivatives affiliates of US banking organizations by registering them as swap dealers and major swaps participants and to set appropriate capital and margin requirements on their derivatives activity.

On August 13, 2012, the CFTC and Securities and Exchange Commission (SEC) published a joint rule that defined and distinguished between a “swap” and a “securities-based swap.” The publication of the final rules triggered deadlines for complying with many CFTC regulations and started the SEC’s sequence for finalizing its derivative rules. Swaps dealers and major swaps participants needed to register with the CFTC by February 11, 2013, and a “phase-in” for clearing interest-rate swaps and credit default swaps was scheduled to begin as the various compliance dates were reached.

Today, registered swap dealers have to comply with a number of new rules governing swaps reporting and recordkeeping, conflict of interest policies, and external business conduct standards. To enhance transparency, the conduct standards require, among other things, that the dealer receive and report certain information and representations from its non-dealer counterparties.

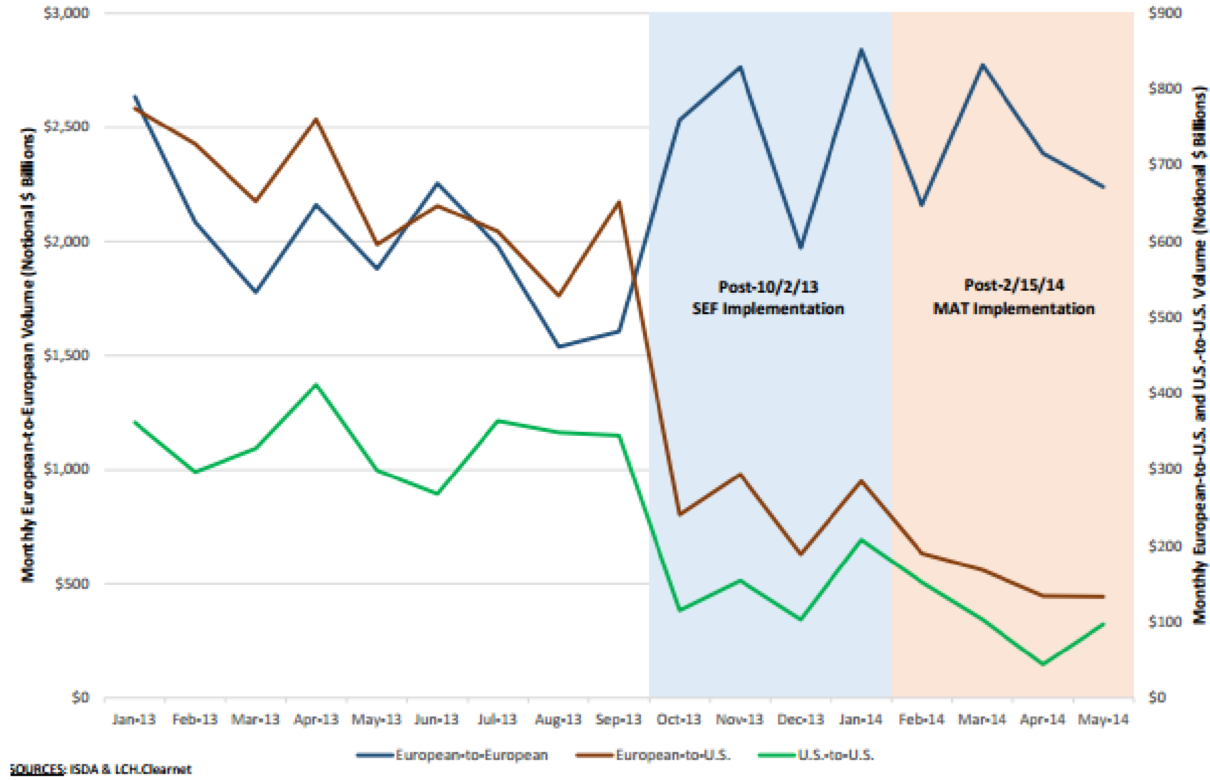
For swaps transactions between foreign entities and firms with a US nexus, the Dodd-Frank Act divides regulatory authority over financial institutions and swaps transactions in confusedly overlapping ways among federal banking regulators (whose rules focus on the behavior of banking institutions) and the SEC and CFTC (whose rules focus on maintaining the integrity of particular markets). The overarching responsibility of every agency is to address risks to US persons and threats to US financial and economic stability, irrespective of the location of the institutions or markets from which they emanate.

In confronting risks that emanate from cross-border activity, US authorities must balance their particular concerns with those of foreign regulators. For this reason, they have sought to avoid conflicting or duplicative requirements, whenever possible. As a framework for achieving this end, US authorities have enunciated a policy which allows a foreign regulator's rules and enforcement to substitute for direct US supervision once US officials have explicitly declared that the foreign regime is comparable to US rules in the objectives it achieves. The Shadow Committee has commented in the past on the difficulty of defining and establishing this kind of comparability. But when it comes to uncleared swaps transactions, so far no foreign country has finalized its rules and only Japan has offered a detailed proposal. This renders the policy of substituted compliance impossible to implement for swaps transactions.

Within the swaps space, jurisdictional issues exist within the US as well. The Dodd-Frank Act requires individual regulatory agencies to set rules for whatever institutions or markets lie within their jurisdiction. Rules that prudential banking regulators have set for foreign subsidiaries of US banks and bank holding companies acting as swaps dealers or major swaps participants focus primarily on defining a US nexus by their effective domicile, extent of parental ownership, and the existence of language establishing an explicit parental guarantee for the swaps transactions.

As the attached graph illustrates, this definition has allowed a large portion of swaps trading by foreign-domiciled swaps dealers and other subsidiaries of major US banking organizations to move their operations outside the span of both direct US prudential supervision and the substituted-compliance framework. This has been accomplished by eliminating explicit parental guarantees from the swaps contracts that these foreign subsidiaries execute, a process which is called "deguaranteeing" the foreign affiliate's swaps. If financial crises have taught us anything, it is that reputation-preserving implicit parental guarantees of subsidiary corporations (such those that applied to special-purpose investment vehicles in 2007-2008) are often as strong as explicit ones. This is why the Shadow Financial Regulatory Committee recommends that US financial regulators directly supervise the foreign subs of major US

banking organizations that are taking the place of US-based dealers and major swaps participants.



SEF Implementation=Requirement that some US swaps transactions take place on Swaps Execution Facilities

MAT (Made Available for Trade) Implementation=Clearing mandate for interest-rate swaps

Source: Culp, Christopher L. “Interest Rate Derivatives Products and Recent Market Activity in the New Regulatory Framework.” Johns Hopkins Institute for Applied Economics, Global Health, & Study of Business Enterprise Universität Bern, Institut für Finanzmanagement Compass Lexecon