

# PAUSE AND HARMONIZE: ISSUES ON THE DODD-FRANK ACT AND ITS CROSS-BORDER APPLICATIONS

Yankun Guo\*

## Abstract

The 2008 financial crisis was a rude awakening for global financial regulators. The lack of transparency and regulation of the derivatives market was a major contributing factor to the global economic recession. As a response, world leaders pledged to bring economic and regulatory reform to their respective nations. In order to meet these goals, the United States proposed the Dodd-Frank Act and, in 2010, the Act was signed into law by President Obama. One of the purposes of Dodd-Frank is to allow financial regulators to police all derivative contracts that may affect the United States; unfortunately, the extraterritorial reach of Dodd-Frank was not well received by many foreign regulators. The Dodd-Frank Act was passed without the United States harmonizing its new regulations with other jurisdictions, resulting in regulatory fragmentation and leading to increased compliance burdens for derivative traders. The differences among each jurisdiction's laws and a lack of harmonization between each jurisdiction could lead to regulatory arbitrage. This Article proposes a pause to the cross-border application of the Dodd-Frank Act until harmonization has been reached.

## I. Introduction

The 2008 financial crisis was a rude awakening for global financial regulators. Financial regulators realized that the lack of transparency and regulation of the derivatives market was a major contributing factor to the global economic recession. As a response to the crisis, world leaders formed the Group of 20 (commonly known as "G20") and pledged to bring economic and regulatory reform to their respective nations.

In order to meet the goals set by G20 and reform domestic regulation, the United States proposed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "Dodd-Frank") in 2009 and was signed into

---

\* J.D., 2015, The John Marshall Law School; B.S. in actuarial science and B.A. in philosophy, 2011, University of Illinois at Urbana-Champaign.

federal law by President Barack Obama on July 21, 2010.<sup>1</sup> One of several purposes of Dodd-Frank is to allow financial regulators to police all derivative contracts that may possibly affect the United States so as to prevent another devastating financial crisis. In July 2013 the Commodity Futures Trading Commission (the “CFTC”) approved the issued interpretive guidance to explain these cross-border applications of the Dodd-Frank Act.<sup>2</sup> Unfortunately, the extraterritorial reach of Dodd-Frank was not well received by many foreign regulators.

The Dodd-Frank Act was passed without the United States harmonizing its new regulations with other jurisdictions, resulting in regulatory fragmentation and causing increased compliance burdens for derivative traders.<sup>3</sup> Other jurisdictions, such as the European Union, found many of Dodd-Frank’s provisions to be troubling and clashing with their own regulator rules, such as the European Market Infrastructure Regulation.<sup>4</sup> The differences in each jurisdiction’s laws and a lack of harmonization between each jurisdiction could lead to regulatory arbitrage as elaborated below in Part III.

This Article proposes that the CFTC could pause the cross-border application of the Dodd-Frank Act or limit the Act’s reach until harmonization has been reached. Part II will provide background as to why the Dodd-Frank Act was enacted. Part III will discuss several issues arising out of the Dodd-Frank Act’s extraterritorial applications and domestic and international pushbacks the Act has received. Part IV will address the critics and counter arguments. Finally, Part V proposes a solution in order to harmonize financial regulations with each other and Part VI concludes.

## II. Background

The 2008 economic crisis was a wakeup call to national and international market regulators. The “financial upheaval” caused more than 26 million Americans to lose their jobs and cost trillions of dollars in household wealth leading to an economy deep in recession.<sup>5</sup> The Financial Crisis Inquiry Commission concluded that

---

1. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

2. *See generally* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013), *available at* <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2013-17958a.pdf> (finalizing the proposed guidance; the effective date of this guidance was July 13, 2013); *see* Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (July 12, 2012), *available at* <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-16496a.pdf>.

3. Brandon Moseley, *Shelby Makes Statement about Dodd-Frank International Harmonization*, ALA. POLITICAL REPORTER (Mar. 26, 2012), <http://www.alreporter.com/archives/archive-2012/2012-march/1701-shelby-makes-statement-about-dodd-frank-international-harmonization.html> (discussing statement made by U.S. Sen. Richard Shelby (Ala. – R) that “foreign regulators and governments have publicly expressed serious concerns about Dodd-Frank”).

4. *See* Joel Clark, *US and European Regulators Clash over Cross-Border Rules*, EUROMONEY (June 12, 2014), <http://www.euromoney.com/Article/3351346/US-and-European-regulators-clash-over-cross-border-rules.html>.

5. FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xv–xvii (2011), *available at* <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> (discussing that for over thirty years of

“widespread failures” in risk management, regulation, and a failure to provide transparency were “devastating to the stability of the nation’s financial markets.”<sup>6</sup> Derivatives contracts along with the housing-market crisis were to blame.<sup>7</sup>

The fall of 2008 also proved how substantial an impact cross-border activity has on the U.S. financial system. This international impact can be seen through a closer look at the near failures of American International Group<sup>8</sup> (“AIG”) and Long-Term Capital Management L.P.<sup>9</sup> (“LTCM”), as well as the total failures of Lehman Brothers<sup>10</sup> and Bear Stearns hedge funds.<sup>11</sup> Other countries also felt the impact of the financial crisis and recognized that globalization effects world trade.<sup>12</sup> As CFTC Chairman Gary Gensler stated, “[t]hrough there were many causes to the crisis in 2008, it was evidence that [over-the-counter] swaps . . . played a central role.”<sup>13</sup>

---

deregulation permitted the banking system and over-the-counter derivatives markets to pick and choose their preferred regulators).

6. *Id.* at xviii.

7. *Id.* at xxv (noting that when the housing market collapsed, the derivatives market was severely destabilized and for fear of worsening an already dire situation the Federal government propped up the derivatives market).

8. CONG. OVERSIGHT PANEL, THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY 1–2 (2010), *available at* <http://www.gpo.gov/fdsys/pkg/CPRT-111JPRT56698/pdf/CPRT-111JPRT56698.pdf> (explaining that the London swap trading operations of its subsidiary, AIG Financial Products (“AIGFP”), had tremendous losses on credit default swaps entered into by AIGFP and guaranteed by AIG. The huge risk AIG incurred triggered massive collateral calls and an acute liquidity crisis. The company only avoided default through support from the Federal Reserve Bank of New York for approximately \$112.5 billion and from the U.S. Department of the Treasury and the Federal Reserve for nearly \$70 billion); *see also* OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES 20 (2009), *available at* [http://www.sig tarp.gov/Audit%20Reports/Factors\\_Affecting\\_Efforts\\_to\\_Limit\\_Payments\\_to\\_AIG\\_Counterparties.pdf](http://www.sig tarp.gov/Audit%20Reports/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf).

9. PRESIDENT’S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 13, 17 (1999), *available at* <http://www.treasury.gov/resource-center/fin-mkts/documents/hedgfund.pdf>. The hedge fund avoided collapse only through rescue by the Federal Reserve Bank of New York after it had a swap book of more than \$1 trillion notional while only having \$4 billion in capital. *Id.* at 13, 17.

10. Lehman Brothers Holding Inc. (“BHI”) and its subsidiary Lehman Brothers International Europe (“LBIE”) had an estimated number of nearly 130,000 OTC derivatives contracts representing \$10 billion in receivables and \$11 billion in payables as of September 2008. LEHMAN BROTHERS INT’L (EUR.), JOINT ADMINISTRATORS’ PROGRESS REPORT FOR THE PERIOD 15 SEPTEMBER 2008 TO 14 MARCH 2009 4, 26 (2009), *available at* <https://www.pwc.co.uk/assets/pdf/lbie-progress-report-140409.pdf>.

11. Global investment firm Bear Stearns suffered substantial losses due to their investments in subprime mortgages and had to file for bankruptcy. They had assumed some risks incurred by foreign affiliates. In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd., 374 B.R. 122, 124 (Bankr. S.D.N.Y. 2007).

12. *See Record Stock Market Falls in 2008*, BBC NEWS (Dec. 31, 2008), <http://news.bbc.co.uk/2/hi/business/7805644.stm> (noting the Dow Jones Industrial Average lost thirty-four percent of its value, the England FTSE 100 fell more than thirty percent, and the Shanghai stock market fell sixty-five percent).

13. Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm’n, Remarks before the London School of Economics (Oct. 13, 2011), *available at* <http://cftc.gov/PressRoom/SpeechesTestimony/opagensler-93>; *see* FIN. CRISIS INQUIRY COMM’N, *supra* note 5, at xv-xxviii. “We conclude over-the-counter derivatives contributed significantly to this crisis. The enactment of legislation in 2000 to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march toward the financial crisis.” FIN. CRISIS INQUIRY COMM’N, *supra* note 5, at xxiv.

## A. Overview of Derivatives and Swaps

A derivative is a contract in which the value is derived from an underlying asset.<sup>14</sup> Derivatives are separated primarily into two groups: (1) over-the-counter (“OTC”) derivatives and (2) exchange traded derivatives (“ETD”). Swaps are a category of derivatives where parties exchange one type of obligation for another.<sup>15</sup> The failure to regulate swaps, specifically credit default swaps (“CDS”), was a key factor in the 2008 financial crisis.<sup>16</sup> OTC derivatives can pose a substantial risk because they are not centrally cleared; particularly, a CDS is an especially risky derivative contract.<sup>17</sup> The cause of the financial crisis was accredited to “loan originators [selling] vast amounts of risky loans that were then repackaged (securitized) and sold off to investors who . . . were unaware of the creditworthiness of the borrowers. These complex instruments then became the underlying assets upon which CDS contracts were based.”<sup>18</sup> The devastation, both domestic and international, was the effect of poorly regulated derivatives and has led to global financial reforms.

## B. Global Response to the 2008 Financial Crisis

As a response to the crisis, in April 2009 leaders of the G20 met in London and pledged to “take action to build a stronger, more globally consistent, supervisory[,] and regulatory framework for the future financial sector, which will support sustainable global growth and serve the needs of business and citizens.”<sup>19</sup> The G20 summit of September 2009 was held in Pittsburgh, Pennsylvania. There, the G20 leaders agreed to wholesome reforms such as having all standardized

---

14. *Derivatives*, OFFICE OF THE COMPTROLLER OF THE CURRENCY, <http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/index-derivatives.html> (last visited Aug. 15, 2015).

15. *Derivatives: Over the Counter, Out of Sight*, ECONOMIST (Nov. 12, 2009), <http://www.economist.com/node/14843667>.

16. Press Release, U.S. Commodity Futures Trading Comm’n, Statement of Support (June 2, 2012), *available at* <http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement062912> (statement from former chairman of the CFTC, Gray Gensler, supporting the guidance on the cross-border application of the Dodd-Frank Act).

17. Credit default swaps were at the heart of AIG’s financial issues and played a significant role in the downfall of Lehman Brothers and Bear Stearns. Robert E. Litan explained CDSs as:

the buyer makes regular payments over some fixed period (typically five years but as short as a single year and as long as ten years) to the seller, who pays the notional amount of the CDS if the issuer of the referenced obligation (such as a bond or a loan) defaults. CDS contracts are sold on the debt of single companies or countries, on specific issues of mortgage securities, or indices of these instruments. Although most of the adverse publicity and commentary about CDS arrangements refers to the “insurance” they provided for mortgage-related securities, in fact only about 1% of all CDS cover these instruments. Over 90% of CDS are written to cover corporate defaults (or corporate indices).

Robert E. Litan, *The Derivatives Dealers’ Club and Derivatives Market Reform: A Guide For Policy Makers, Citizens, and Other Interested Parties* 13 (2010), *available at* [http://www.brookings.edu/~media/research/files/papers/2010/4/07%20derivatives%20litan/0407\\_derivatives\\_litan.pdf](http://www.brookings.edu/~media/research/files/papers/2010/4/07%20derivatives%20litan/0407_derivatives_litan.pdf).

18. Nicolas W. Turner, *Dodd-Frank and International Regulatory Convergence: The Case of Mutual Recognition*, 57 N.Y.L. SCH. L. REV. 391, 402 (2012-2013).

19. *G20 Global Plan For Recovery and Reform, April 2009*, COUNCIL ON FOREIGN RELATIONS, ¶13 (Apr. 2, 2009), <http://www.cfr.org/financial-crises/g20-global-plan-recovery-reform-april-2009/p19017>.

OTC derivatives contracts cleared through a center counterparty (“CCP”) and traded on exchanges or electronic trading platforms by the end of 2012.<sup>20</sup>

To fulfill its obligations, the European Union (“EU”) enacted the European Market Infrastructure Regulation (“EMIR”), implementing the G20 recommendations and goals.<sup>21</sup> This regulation increased the use of CCPs for clearing OTC derivative trading, reporting to trade repositories, and installing risk mitigation requirements for uncleared derivatives.<sup>22</sup> The EU also enacted the Markets in Financial Instruments Directive (“MiFID II” or “MiFIR”) to set trading obligations and a code of conduct.<sup>23</sup>

Similarly, on July 21, 2010, President Barack Obama signed the Dodd-Frank Act to fulfill the United States’ obligations under the G20.<sup>24</sup> Title VII of the Dodd-Frank Act amended the Commodity Exchange Act (“CEA”),<sup>25</sup> establishing a new comprehensive framework for swaps. Specifically, section 722(d) of the Dodd-Frank Act amended the CEA by adding section 2(i), which prohibited the applicability of the Act to “activities outside the United States unless those activities (1) have a direct and significant connection with activities in, or effect on, commerce of the United States.”<sup>26</sup>

Concerned with how section 2(i) would be interpreted, the CFTC issued, after notice and comment, its Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations (“Guidance”) to outline the Commission’s general policy regarding cross-border swap activities and to state “with precision when particular requirements do and do not apply.”<sup>27</sup> Notably, the Guidance addresses the CFTC’s interpretation of a “U.S. Person” swap dealer and major swap participant’s (MSP) registration, transaction level, and entity-level requirements, and substituted compliance.<sup>28</sup>

---

20. *Leaders’ Statement: The Pittsburgh Summit*, G-20 7–9 (2009), available at [http://www.treasury.gov/resourcecenter/international/g7g20/Documents/pittsburgh\\_summit\\_leaders\\_statement\\_250909.pdf](http://www.treasury.gov/resourcecenter/international/g7g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf). The following nations were the participants of the G-20: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States, European Union. See *2009 G-20 Pittsburgh Summit* (2015), WIKIPEDIA, [https://en.wikipedia.org/wiki/2009\\_G-20\\_Pittsburgh\\_summit](https://en.wikipedia.org/wiki/2009_G-20_Pittsburgh_summit) (last visited Sept. 15, 2015).

21. EUROPEAN COMM’N, PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ON OTC DERIVATIVES, CENTRAL COUNTERPARTIES AND TRADE REPOSITORIES 3 (2010), available at [http://ec.europa.eu/internal\\_market/financial-markets/docs/derivatives/20100915\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/financial-markets/docs/derivatives/20100915_proposal_en.pdf).

22. *Id.* at 6.

23. See *Markets in Financial Instruments Directive (MiFID) II*, EUROPEAN SEC. & MKTS. AUTH., <http://www.esma.europa.eu/page/Markets-Financial-Instruments-Directive-MiFID-II> (last visited Aug. 15, 2015).

24. The Wall Street Transparency and Accountability Act, 15 U.S.C. § 8301-44 (2010); see generally *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

25. Commodity Exchange Act, 7 U.S.C. § 1 (2001).

26. 7 U.S.C. § 2(i)(1) (2010).

27. Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45292, 45297 (July 26, 2013).

28. *Id.* at 45301 (U.S. person defined under Section IV(A)); *id.* at 45317 (MSP registration found under Section (IV)(B)(1)); *id.* at 45337-45338 (transaction level and entity-level requirements found under Section (IV)(E)(3)(a) and (IV)(E)(3)(b)); *id.* at 45340 (substituted compliance found under Section (IV)(F)).

### III. The CFTC Should Pause or Limit the Cross-Border Applications of the Dodd-Frank Act until the United States Harmonizes with Foreign Financial Regulators

Harmonization, or convergence, “occurs when legal systems become more similar to one another, usually through the deliberate adoption of policies.”<sup>29</sup> Given the global nature of derivatives and other financial instruments, it is essential for nations to work together and carry out the goals of the G20 and to repair and strengthen financial regulations in order to prevent another market collapse and subsequent recession, like that of 2008. However, the CFTC’s bold decision to enact the Dodd-Frank Act and its Guidance while extending extraterritorial applications was done without harmonizing U.S. regulations with other nations’ laws and regulations.<sup>30</sup> Absent harmonization, issues such as regulatory arbitrage and market fragmentation arise from discrepancies in regulations, such as issues with central clearing, margin requirements, or substituted compliance.

#### A. The CFTC Should Pause or Limit the Dodd-Frank Act’s Current Cross-Border Application Because It Is Creating Unanticipated Consequences

##### 1. *Regulatory Arbitrage*

National regulators fear that pursuing new and aggressive regulatory initiatives, such as the Dodd-Frank Act, will drive financial activity offshore. Regulatory arbitrage is a tactic employed by companies looking to avoid unfavorable regulations by moving their activities to a different jurisdiction, typically overseas.<sup>31</sup> Author Sean J. Griffith presents the issue as follows:

A regulated entity’s movement of business from Jurisdiction A, which has adopted Regulatory Strategy X addressing Problem Y, to Jurisdiction B, which has not adopted Regulatory Strategy X and in which it is therefore less costly to conduct business.<sup>32</sup>

The ability to evade regulations through arbitrage is problematic for various reasons. The U.S. Under-Secretary of the Treasury for International Affairs, Lael Brainard, testified before Congress that regulatory arbitrage “means a ‘race to [the] bottom’ for standards and protections . . . and it may increase the possibility of future

---

29. Turner, *supra* note 18, at 398–99.

30. See Moseley, *supra* note 3.

31. Regulatory arbitrage is defined as “A practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavorable regulation. Arbitrage opportunities may be accomplished by a variety of tactics, including restructuring transactions, financial engineering and geographic relocation. Regulatory arbitrage is difficult to prevent entirely, but its prevalence can be limited by closing the most obvious loopholes and thus increasing the costs associated of circumventing the regulation.” *Regulatory Arbitrage*, INVESTOPEDIA, <http://www.investopedia.com/terms/r/regulatory-arbitrage.asp> (last visited Aug. 15, 2015).

32. Sean J. Griffith, *Substituted Compliance and Systemic Risk: How to Make A Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291, 1326 (2014).

financial instability, if riskier activities migrate to areas with less transparency, looser regulation, and laxer supervision.”<sup>33</sup>

The risk of regulatory arbitrage is imminent because of the profound regulatory differences between the United States and other jurisdictions. Rather than adopting incremental reforms, “the CFTC has issued seventy-three proposed rules, four advanced notices of proposed rulemaking, six proposed exemptive orders and one other notice” to reform OTC derivatives in a very short timeframe.<sup>34</sup> Not only has it been difficult for U.S. swap dealers to navigate the Act’s sea of new regulations, it has been a nightmare for foreign customers and swap dealers to interpret these new regulations and apply them to their own businesses. The costs to implement these new regulations are fairly high and are:

requiring participants in the OTC derivatives industry to completely remake and restructure their business practices and their infrastructure in order to accommodate such reforms as mandatory exchange trading and clearing of OTC derivatives (with certain key exceptions), position limits, providing initial and variation margin for uncleared swaps, capital requirements on dealers, and new business conduct standards.<sup>35</sup>

Thus, the burden of compliance incentivizes businesses that are able to move to a different jurisdiction to do so.

To prevent and cure regulatory arbitrage, there must be a harmonization or convergence of financial regulations. Professor Eric Pan noted, “The ability of cross-border financial institutions to shift their operations and services among jurisdictions means that any new forms of regulation must be in coordination with other countries.”<sup>36</sup> Regulatory unity must be achieved or else cross-border entities will shift the balance of their operations overseas to more favorable venues with less comprehensive regulations and oversight.

## *2. Effects of Market Fragmentation*

Absent harmonization, the financial markets will be fragmented and inconsistent across nations, causing undesirable effects. Belinda Gibson, former Deputy Chairman of the Australian Securities and Investments Commission

---

33. See *Financial Regulatory Reform: The International Context: Hearing Before the H. Comm. on Fin. Servs.*, 112th Cong. 12 (2011).

34. See *generally Proposed Rules, Guidance and Exemptive Orders*, COMMODITY FUTURES TRADING COMM’N, <http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankProposedRules/index.htm> (last visited Aug. 15, 2015).

35. Christian A. Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction and Dodd-Frank: The Implications of US Global OTC Derivative Regulation*, 14 NEV. L.J. 542, 569 (2014).

36. Eric J. Pan, *The Future International Financial Regulations*, 40 CII THINKPIECE 1, 3 (June 2010), available at [http://www.cii.co.uk/downloaddata/TP40\\_Pan\\_Intnatl\\_Fin\\_Regn\\_7June2010.pdf](http://www.cii.co.uk/downloaddata/TP40_Pan_Intnatl_Fin_Regn_7June2010.pdf) (arguing that regulatory arbitrage “makes it essential for national regulators to work through international bodies and regulatory networks like the FSB, Basel and IOSCO).

(“ASIC”), wrote to Gary Gensler on August 27, 2012 regarding the concerns that financial regulators were having.<sup>37</sup> Ms. Gibson wrote:

some of the proposed requirements as they currently stand may have significant effects on financial markets and institutions outside of the U.S. We believe a failure to address these concerns could have unintended consequences, including increasing market fragmentation and, potentially, systemic risk in these markets, as well as unduly increasing the compliance burden on industry and regulators.<sup>38</sup>

It is already estimated that the Dodd-Frank Act “imposed over \$17.8 billion in direct compliance costs.”<sup>39</sup> This figure, however, does not include the costs imposed by EMIR and other foreign regulations. Given the nature of derivative trades, each transaction could be subject to several different jurisdictions resulting in very costly compliance burdens.

## B. The CFTC Needs to Work with Other Jurisdictions More Diligently to Harmonize Its Regulations

The complicated nature of globally traded OTC derivatives makes it incredibly important to have uniform application standards. Without uniform global regulations “a single swap may be negotiated and executed between counterparties located in two different countries, booked in a third country[,] and risk-managed in a fourth country, trigger[ing] swaps regulation in multiple jurisdictions simultaneously.”<sup>40</sup> Additionally, most of these OTC derivatives are long-term contracts with ongoing payments, deliveries, and other obligations that might have a lifespan lasting many years. The risk of these OTC derivatives being subject to different jurisdictional requirements midway through a transaction is likely when there is no uniform regulatory scheme.<sup>41</sup> These risks arise due to regulations imposed on margin, substituted compliance, and swap execution facilities of the Dodd-Frank Act.

---

37. Letter from Belinda Gibson, former Deputy Chairman, Australian Sec. & Invs. Comm’n (“ASIC”) et al. to Gary Gensler, Chairman, Commodity Futures Trading Comm’n, *CFTC’s Proposed Guidance on Cross-Border Application of Certain Swap Provisions of Commodity Exchange Act* “Proposed Guidance (Aug.27, 2012), available at <http://comments.cftc.gov/Handlers/PdfHandler.ashx?id=24604>.

38. *Id.*

39. Sam Batkins, *Week in Regulation*, AM. ACTION FORUM (Feb. 21, 2014), <http://americanactionforum.org/week-in-regulation/regulatory-costs-trump-benefits>.

40. *Comment Letter from the Securities Industry and Financial Market Association to Multiple Federal Agencies on the Extraterritorial Application of Title VII of the Dodd-Frank Act*, SIFMA 2 (Feb. 3, 2011), available at <http://www.sifma.org/issues/item.aspx?id=23247>.

41. Lucy McKinstry, *Regulating a Global Market: The Extraterritorial Challenge of Dodd-Frank’s Margin Requirements for Uncleared OTC Derivatives & A Mutual Recognition Solution*, 51 COLUM. J. TRANSNAT’L L. 776, 806 (2013).

*1. Margin Requirements*

Title VII of the Dodd-Frank Act requires margin for uncleared derivatives in order to alleviate some of the risk,<sup>42</sup> but other jurisdictions have different margin requirements than those imposed by the CFTC.<sup>43</sup> The Dodd-Frank Act amended the CEA by adding section 4s and the Act is applicable to banks and non-banks, enumerated regulation, and registration of swap dealers and MSPs.<sup>44</sup> Specifically, sections 4s(e)(2)(A)(ii) and 4s(e)(2)(B)(ii) requires initial and variation on the margin for swap dealers and MSPs on all uncleared swap transactions.<sup>45</sup> Section 4s(e)(3)(A) acknowledges the “greater risk to the swap dealer or major swap participant and the financial system arising from the use of swaps that are not cleared.”<sup>46</sup> Noncash collateral is allowed under section 4s(e)(3)(C) as long as the pertinent regulators, such as banks and the CFTC “find it consistent with preserving the financial integrity of the derivatives markets and the stability of the U.S. financial system.”<sup>47</sup> The purpose of having heightened margin requirements for uncleared derivatives versus cleared derivatives is “to push market participants towards trading in cleared instruments, to the extent possible, and to collateralize the risks of OTC derivatives otherwise.”<sup>48</sup>

Ideally, maintaining a margin requirement will protect against losses from counterparty default because it requires a party to provide real money as collateral for their obligations under a derivative contract.<sup>49</sup> The CFTC has the authority to regulate all entities, such as imposing a certain margin requirement on these entities, considered to be a “U.S. person”<sup>50</sup> or off shore activities that have a “direct and significant” connection to, or have an effect on, U.S. commerce.<sup>51</sup> The Commission further explained and expanded on the definition of a “U.S Person” in its Guidance, stating that any “U.S. Person” will have to comply with all CFTC regulations including “entity-level” and “transaction-level” requirements.<sup>52</sup> The Guidance further elaborates that some non-U.S. person entities that engage in swap transactions with “U.S. persons” are required to comply with “transaction-level” requirements.<sup>53</sup>

---

42. *See Regulatory Reform and the Derivatives Market: Hearing Before the Comm. on Agric., Nutrition, and Forestry*, 111th Cong. 8, 89 (2009). Gary Gensler, Chairman of the CFTC states, “it is important that tailored or customized swaps that are not able to be cleared or traded on an exchange are sufficiently regulated.” *Id.*

43. *See Months to Go: Margin on Bilateral OTC Trades*, CALYPSO (Mar. 19, 2015), <http://www2.calypso.com/months-to-go-margin-on-bilateral-otc-trades/>.

44. Dodd-Frank Wall Street Reform and Consumer Protection Act, 7 U.S.C. § 4s (2010); *see also* McKinstry, *supra* note 41, at 797.

45. § 4s; *see* McKinstry, *supra* note 41, at 797.

46. § 4s.

47. *Id.*; McKinstry, *supra* note 41, at 797.

48. McKinstry, *supra* note 41, at 797.

49. *See id.* at 784.

50. Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41214, 41218 (July 12, 2012) (codified at 17 C.F.R. ch. 1).

51. Dodd-Frank Wall Street Reform and Consumer Protection Act, 7 U.S.C. § 2(i)(1) (2010).

52. Per the Guidance, a “U.S. person” is defined as a natural person who is a resident of the United States, any corporation, partnership, limited liability company, etc. *See* Interpretive Guidance and Policy Statement, *supra* note 2, at 45,302; DERIVATIVES: GLOBAL CONVERGENCE BECOMES GLOBAL CONFUSION, PWC 4 (2013), *available at* [http://www.pwc.com/en\\_US/us/financial-services/regulatory-services/publications/assets/pwc-closer-look-derivatives-cross-border-secure.pdf](http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/pwc-closer-look-derivatives-cross-border-secure.pdf).

53. Interpretive Guidance and Policy Statement, *supra* note 2, at 45,348, 45,350.

In other words, non-U.S. persons engaged in swaps with U.S. persons will be required to abide by the CFTC's margin requirements.<sup>54</sup> Also, Transaction Level rules apply to non-U.S. swap dealers facing "U.S. Person" counterparties.<sup>55</sup>

Since Transaction Level requirements, which include margin, apply to non-US swap dealers, a problem arises when other jurisdictions have different margin requirements. The EMIR requires that financial counterparties in un-cleared trades have additional risk management procedures in place, including "the timely, accurate, and appropriately segregated exchange of collateral in relation to OTC derivatives entered into on or after [August 16, 2012]."<sup>56</sup> The European Supervisory Authorities (ESAs) published earlier in April 2014 the consultation paper and draft regulatory technical standards ("RTS") delineating margin requirements to help mitigate risk for OTC derivatives not cleared by a CCP under Article 11 of the EMIR.<sup>57</sup> The EU's margin requirements follow the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) or BCBS-IOSCO standard.<sup>58</sup>

When different jurisdictions have varying margin requirements, counterparties to a cross-border derivative contract will have to comply with the most conservative margin requirements.<sup>59</sup> Here, a simple comparison of initial margin requirement will be made. The draft RTS states that the EMIR's initial margin requirements follow a "two-step approach to mark-to-market methods and the model-based approach broadly in line with requirements in the BCBS-IOSCO standard (99% confidence interval, 10 day risk horizon, netting only within, not across, asset classes, model validation, back-testing and regular audit process)."<sup>60</sup> On the other hand, the CFTC requires margins be determined by the regulators. The CFTC proposes that the initial margin be calculated by a model approved by the Commission and:

- (i) is used by a derivatives clearing organization for clearing swaps, (ii) is used by an entity subject to oversight by a prudential regulator[,] or (iii) made available for

---

54. DERIVATIVES: GLOBAL CONVERGENCE BECOMES GLOBAL CONFUSION, *supra* note 52, at 8.

55. *Id.*

56. *EU and US Derivatives Regulatory Regime*, 3 available at <http://media.mofo.com/files/Uploads/Images/130925-Comparison-of-EU-US-Derivatives.pdf>.

57. See Clifford Smout & Kai Kohlberger, *ESAs Outline Details on EMIR Margin Requirements for Non-Cleared OTC Derivatives*, DELOITTE (Apr. 17, 2014, 4:16 PM), <http://blogs.deloitte.co.uk/financialservices/2014/04/esas-outline-details-on-emir-margin-requirements-for-non-cleared-otc-derivatives.html>; JOINT COMM. OF THE EUROPEAN SUPERVISORY AUTH., CONSULTATION PAPER: DRAFT REGULATORY TECHNICAL STANDARDS ON RISK-MITIGATION TECHNIQUES FOR OTC-DERIVATIVE CONTRACTS NOT CLEARED BY A CCP UNDER ARTICLE 11(15) OR REGULATION(EU) No 648/2012 6-11 (Apr. 14, 2014), available at <http://www.eba.europa.eu/documents/10180/655149/JC+CP+2014+03+%28CP+on+risk+mitigation+for+OTC+derivatives%29.pdf>.

58. BD. OF THE INT'L ORG. OF SEC. COMM'NS, BASE COMM. ON BANKING SUPERVISION, MARGIN REQUIREMENTS FOR CENTRALLY CLEARED DERIVATIVES 1 (Sept. 2013), available at <https://www.bis.org/publ/bcbs261.pdf>; Smout & Kohlberger, *supra* note 57. "The draft RTS also provides further details on the methods that counterparties may use to calculate initial margin requirements. In summary, the draft RTS confirms the EMIR two-step approach to mark-to-market methods and the model-based approach broadly in line with requirements in the BCBS-IOSCO standard (99% confidence interval, 10 day risk horizon, netting only within, not across, asset classes, model validation, back-testing and regular audit process)." Smout & Kohlberger, *supra* note 57.

59. McKinstry, *supra* note 41, at 802-03.

60. Smout & Kohlberger, *supra* note 57.

licensing to any market participant by a vendor. If no such model is available, initial margin would be calculated by selecting a comparable cleared swap or futures contract and applying a multiplier set forth in the rule.<sup>61</sup>

Depending on how much money each jurisdiction's model amounts to, counterparties to a cross-border derivative contract will have to comply with the most stringent requirement. If the CFTC imposes the more stringent requirement, it could cause non-U.S. entities to avoid transactions subject to the CFTC's regulation, resulting in regulatory arbitrage.

Fragmented margin requirements also show how burdensome the cost of compliance could be. Deloitte's EMEA Centre for Regulatory Strategy estimated that the "additional costs arising from the new initial margin requirements for non-cleared transactions amount to €50 per €1 million notional" based on the BCBS-IOSCO standards.<sup>62</sup> Although these initial margin requirements only apply to certain market participants, it still reflects a well-known concern that compliance burdens will be extremely costly. As author Lucy McKinstry points out, "absent clear and consistent-border coordination, this race-to-the-top requirement could lead to regulatory gaps in the global OTC market or overlapping and potentially conflicting regulations."<sup>63</sup> This will "vitiate" the core purpose of having these margin requirements and frustrate their goal of offsetting risk efficiently.<sup>64</sup>

## *2. Substituted Compliance*

To curb some of these conflicting cross-border regulation issues, the CFTC proposed waiving some Title VII requirements for a non-U.S. person in a jurisdiction with comparable regulatory requirements.<sup>65</sup> "Substituted compliance" is the Commission's attempt to stay consistent with section 2(i) of the CEA comity principles, and allow "a non-US swap dealer or MSP [to] comply with [a] foreign jurisdiction's law and regulations in lieu of compliance with the attendant Entity-Level Requirements and/or Transaction-Level Requirements."<sup>66</sup> Substituted compliance can be used to waive various requirements including margin requirements.<sup>67</sup>

---

61. *Proposed Rules Regarding Margin For Uncleared Swaps*, OFFICE OF PUB. AFFAIRS, COMMODITY FUTURES TRADING COMM'N 1-2, available at [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/um\\_fact\\_sheet.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/um_fact_sheet.pdf) (last visited Aug. 15, 2015).

62. Smout & Kohlberger, *supra* note 57; EMEA CENTRE FOR REGULATORY STRATEGY, OTC DERIVATIVES: THE NEW COST OF TRADING 11 (2014), <http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-otc-derivatives-april-14.pdf>.

63. McKinstry, *supra* note 41, at 803.

64. *Id.*

65. *Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations*, OFFICE OF PUB. AFFAIRS, COMMODITY FUTURES TRADING COMM'N 3 [http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/crossborder\\_factsheet\\_final.pdf](http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/crossborder_factsheet_final.pdf) (last visited Aug. 15, 2015).

66. *Id.*

67. Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41214, 41228 (July 12, 2012) (codified at 17 C.F.R. ch. 1). "Generally, substituted compliance with respect to margin requirements will be available for: (1) swap transactions between non-U.S. swap dealers or non-U.S. major swap participants and non-U.S. counterparties guaranteed by a U.S. person, (2) swap transactions involving U.S.

To be considered for Substituted Compliance, foreign regulators may apply with the Commission. The review is based on considering the “objectives of a foreign jurisdiction’s swap regulations and will base its analysis on a comparison of specific foreign requirements against Commodity Exchange Act provisions and CFTC regulations in 13 categories of regulatory obligations.”<sup>68</sup> Factors include how comprehensive the foreign regulator’s supervisory compliance program is and whether the foreign regulator can “support and enforce its oversight of the registrant’s branch or agency with regard to such activities to which submitted compliance applies.”<sup>69</sup>

The CFTC has approved some comparability determinations. Certain swap provisions of the Dodd-Frank Act were approved under Substituted Compliance for Australia, Canada, the EU, Hong Kong, Japan, and Switzerland.<sup>70</sup> This, however, does not mean entities in these jurisdictions are exempt from all regulations, only a select few. In March 2014 Kay Swinburne, a member of the European Parliament, was still asking U.S. regulators to “recalibrate” their approach and cross-border regulations. At the Futures Industry Association’s Annual Conference in Boca Raton, Florida, Swinburne stated:

I think the really important thing to remember is the European Union is a collection of 28 countries, we already compromise very well, member states have got to decide what is really important to them, and they have their red lines in terms of negotiations, but they have to let everything else that’s less important be compromised and be subject to a negotiated settlement at the end.<sup>71</sup>

The rest of the world waits for the United States and the EU to harmonize their derivative regulations.<sup>72</sup> The EU struggled to meet the June 15, 2014 deadline to comply with the CFTC’s clearinghouse regulations and swap execution facilities (“SEFs”) after pushing back the CFTC’s deadline several times.<sup>73</sup> Still today, the EU

---

affiliate conduits and (3) swap transactions between a foreign branch or agency of a U.S. person and a non-U.S. person counterparty.” McKinstry, *supra* note 41, at 803 n.147.

68. *CFTC Finalizes Cross-Border Swaps Guidance and Establishes Compliance Schedule*, DAVIS POLK & WARDWELL LLP 10 (July 30, 2013), available at [http://www.davispolk.com/sites/default/files/07.30.13.CFTC\\_Cross\\_Border\\_0.pdf](http://www.davispolk.com/sites/default/files/07.30.13.CFTC_Cross_Border_0.pdf).

69. Edward F. Green & Ilona Potiha, *Issues in the Extraterritorial Application of Dodd-Frank’s Derivatives and Clearing Rules, the Impact on Global Markets and the Inevitability of Cross-Border and US Domestic Coordination* 1, 8 n.37 (unpublished paper), available at [http://web.law.columbia.edu/sites/default/files/microsites/law-economics-studies/Greene\\_Paper.pdf](http://web.law.columbia.edu/sites/default/files/microsites/law-economics-studies/Greene_Paper.pdf).

70. Press Release, U.S. Commodity Futures Trading Comm’n, CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes (Dec. 20, 2013), available at <http://www.cftc.gov/PressRoom/PressReleases/pr6802-13>; see also *Compatibility Determinations for Substituted Compliance Purposes*, U.S. COMMODITY FUTURES TRADING COMM’N, <http://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/index.htm> (last visited Aug. 20, 2015).

71. Mike Kentz, *DERIVATIVES: MEP Calls For US Cross-Border Respite*, KAY SWIBURNE MEP (Dec. 3, 2014), <http://www.kayswinburne.co.uk/articles/DERIVATIVESMEPcallsforUScrossborderrespiteMikeKentz120314/493>.

72. Rebecca Christie & Silla Brush, *World Waits For U.S. EU to Solve Derivatives Spat: Faull*, BLOOMBERG BUS. (Apr. 9, 2014, 12:14 PM), <http://www.bloomberg.com/news/2014-04-09/world-waits-for-u-s-eu-to-solve-derivatives-spat-faull.html>.

73. *European Commission Keen to Delay Bank Rules on Clearing*, FIN. TIMES (May 8, 2014, 12:47 PM), <http://www.ft.com/cms/s/0/434cebd4-d603-11e3-a239-00144feabdc0.html> (discussing the EU’s issues with complying with the U.S. clearing rules).

and the United States are trying to negotiate an agreement to resolve the differences between the EU and U.S. clearing houses.<sup>74</sup> One way the CFTC can avoid pushing back deadlines for the EU and other countries is to simply re-evaluate the cross-border applications of the Dodd-Frank Act and to harmonize those provisions with other nations. Simply reaching a bilateral agreement with the EU will resolve many of the current issues the CFTC and other nations are facing in light of the current regulatory scheme.

### *3. Swap Execution Facilities*

The EU is still struggling to meet regulatory standards equivalent to, and comparable with, the Swap Execution Facilities (SEFs).<sup>75</sup> The Dodd-Frank Act created SEFs as new trading facilities for multiple participants to execute or trade swaps by accepting bids and offers.<sup>76</sup> These SEFs were one of the three issued rules to move “bilaterally traded swaps onto execution platforms that offer many-to-many trade functionality.”<sup>77</sup> In addition to the standards required to register and operate SEFs, the Commission also requires that mandatory cleared swaps are either traded on SEFs or designated contract markets (“DCMs”) and identify large notional block trades that can still be executed off exchange.<sup>78</sup> This will preclude OTC derivatives from being traded bilaterally.

On the other hand, the EU under the European Union's Markets in Financial Instruments Directive (“Mifid”) has not designated any specific facilities for swaps to be traded on.<sup>79</sup> The EU currently has multilateral trading facilities (MTFs), and only once the MiFID II is in place, “[can swaps] be executed on regulated exchanges, multilateral trading facilities, organized trading facilities and on an OTC basis.”<sup>80</sup> Although only mandatory cleared swaps must be traded on SEFs, the Dodd-Frank Act’s extraterritorial reach requires that MTFs meet regulatory standards equivalent to those designed for SEFs, which is proving to be a significant challenge.<sup>81</sup> A senior manager at a London-based MTF exclaimed:

---

74. Douwe Miedema, *EU and U.S. Struggle to Resolve Derivatives Clearing Dispute*, REUTERS (Feb. 25, 2015, 12:39 PM), <http://www.reuters.com/article/2015/02/25/us-financial-regulations-swaps-idUSKBN0LT1Z020150225> (noting that as of February 2015, the EU and the United States were still negotiating clearing house rules).

75. Anish Puarr, *Swaps Uncertainty Reigns Despite Revised CFTC Deadline*, FIN. NEWS (Mar. 25, 2014), <http://www.efinancialnews.com/story/2014-03-25/eu-swap-platforms-await-detail-from-cftc-on-dodd-frank-compliance>.

76. *EU and US Derivatives Regulatory Regime*, *supra* note 56, at 7.

77. *FS Regulatory Brief: Derivatives: SEFs – Opening Bell Sounds*, PWC 1 (June 2013), [http://www.pwc.com/en\\_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-derivatives-sefs-opening-bell-sounds.pdf](http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/fs-reg-brief-derivatives-sefs-opening-bell-sounds.pdf). “Many-to-many” describes a trading platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant.” *Id.*

78. *Id.*

79. *EU and US Derivatives Regulatory Regime*, *supra* note 56, at 7.

80. *Id.* at 7–8.

81. Michael Watt, *European MTFs in Limbo Over CFTC Compliance Ahead of May 15 Deadline*, FX WEEK (Apr. 3, 2015), <http://www.fxweek.com/fx-week/news/2337943/european-mtfs-in-limbo-over-cftc-compliance-ahead-of-may-15-deadline> (The MTF compliance deadline was set for May 15, 2015).

[I have] no idea what these additional compliance standards will look like. Every day this continues, compliance gets more difficult, because time is running out. What are they going to do? Wait until [the compliance deadline] to tell us what is going on? That would be a disaster. The whole process has just been ridiculous.<sup>82</sup>

It is likely that other jurisdictions have similar frustrations to those of Europe with trying to comply with SEF requirements, which is another compelling reason why the CFTC should put the cross-border applications of the Dodd-Frank Acts on hold until these wrinkles have been ironed out.

The creation of SEFs increases the transparency of the OTC derivatives markets—a goal of the G20. The final SEF rules require that any “person operating a platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant must register either as an SEF [or a DCM, under existing rules].”<sup>83</sup> Registrants must provide the CFTC with documentation and establish that they can operate in compliance with SEF rules.<sup>84</sup> Only swap products approved by the CFTC may be traded.<sup>85</sup> Also, note that an SEF will operate as a self-regulatory organization (“SRO”) and will be required to have a Chief Compliance Officer (“COO”) and meet other requirements.<sup>86</sup>

These CFTC rules are intended to improve transparency, information asymmetries, and other risks posed by OTC derivatives. The EU, for example, has been trying to meet the compliance deadline and in doing so drafted the MiFID II; however, MiFID II will not be implemented until at least 2016.<sup>87</sup> It is going to be even harder for other jurisdictions, those less developed than the EU, to comply with the CFTC in a timely fashion.

As a response to foreign exchanges not able to meet the CFTC’s compliance deadlines, the CFTC did not provide any no-action letters giving complete relief. Rather, the CFTC was lenient with the foreign regulators’ attempts at complete compliance. On April 9, 2014, two divisions of the CFTC, the Division of Market Oversight (“DMO”) and the Division of Swap Dealer and Intermediary Oversight (“DSIO”), issued no-action Letter 14-46 (“Amended Qualifying MTF Letter”).<sup>88</sup> It gave conditional relief to MTFs and users of MTFs.<sup>89</sup> Although these letters provided some

---

82. *Id.*

83. *FS Regulatory Brief*, *supra* note 77, at 2.

84. *Id.*

85. *Id.* New products will be considered by the CFTC by looking at several factors: (1) “Whether there exist ready and willing buyers and sellers of the product”; (2) “The frequency or size of transactions”; (3) “The trading volume”; (4) “The number and type of market participants”; (5) “The bid/ask spread”; (6) “The usual number of resting firm or indicative bids and offers”. *Id.*

86. *Id.* at 4.

87. Watt, *supra* note 81.

88. CFTC Letter 14-46, Conditional No-Action Relief with respect to Swaps Trading on Certain Multilateral Trading Facilities Overseen by Competent Authorities Designated by European Union Member States (April 9, 2014).

89. The Amended Qualifying MTF Letter generally tracks the terms of the Prior Letter, so it also provides three forms of conditional relief to MTFs and users of MTFs:

- an MTF meeting certain stated compliance requirements (each, a Qualifying MTF) may permit US persons or persons located in the United States the ability to trade or execute swaps on or through the MTF without requiring such MTF to register as a swap execution facility

relief to MTFs and their users, they also provided additional requirements that had to be met before relief could be obtained.

The CFTC believes that the amendments and revision were made in the “spirit of international cooperation.”<sup>90</sup> In July 2013, European Commissioner Michel Barnier and CFTC Chairman Gary Gensler announced “Path Forward”—a cooperative, cross-border plan for derivatives regulation.<sup>91</sup> While the Path Forward and no-action letters indicate the CFTC is taking harmonization seriously, there still is no reasonable time frame for compliance. Also, there is still the issue as to whether the CFTC is allowed to extend its jurisdiction beyond the United States’ borders.

### C. CFTC Faces Domestic Pushbacks For Improper Agency Rulemaking Procedures

The CFTC is currently facing domestic lawsuits and international pressures to overturn the Guidance. The Securities Industry and Financial Markets Association (“SIFMA”), the International Swaps and Derivatives Association, Inc. (“ISDA”), and the Institute of International Bankers (“IIB”) filed a lawsuit in December 2013 against the CFTC challenging the Guidance’s cross-border rules.<sup>92</sup> These three associations (herein, collectively referred to as “Plaintiffs”) are challenging the CFTC for (1) unlawfully circumventing the requirements of the Administrative Procedure Act and the Commodity Exchange Act by characterizing its regulations as guidance; (2) failing to conduct any cost-benefit analysis, as required by law; (3) conducting a flawed rulemaking process; and (4) imposing a series of rules that are contrary to the spirit and the letter of international cooperation and may harm global markets.<sup>93</sup> They specifically asked the U.S. District Court for the District of Columbia to vacate

---

(SEF) pursuant to Section 5h(a)(1) of the United States Commodity Exchange Act (CEA) and CFTC Rule 37.3(a)(1);

- swap market participants executing swaps on a Qualifying MTF are relieved from any applicable trade execution mandate pursuant to Section 2(h)(8) of the CEA or any otherwise applicable obligations to report such swaps pursuant to Parts 43 and 45 of the CFTC Rules; and
- swap dealers and major swap participants (together, Swap Entities) executing swaps on Qualifying MTFs are relieved from certain conduct of business requirements under Part 23 of the CFTC Rules.

Tim Aaron, et al., *CFTC Issues Updated Relief For Cross-Border Trading of Swaps on Qualifying Multilateral Trading Facilities in the European Union*, MONDAQ (Apr. 30, 2014), available at <http://www.mondaq.com/unitedstates/x/310400/Commodities+Derivatives+Stock+Exchanges/CFTC+Issues+Updated+Relief+For+CrossBorder+Trading+Of+Swaps+On+Qualifying+Multilateral+Trading+Facilities+In+The+European+Union>.

90. Emily Perryman, *CFTC Issues ‘No-Action Letter’ For Swaps Trading on EU Multilateral Trading Facilities*, HEDGEWEEK (Oct. 4, 2014, 4:00 PM), <http://www.hedgeweek.com/2014/04/10/200556/cftc-issues-%E2%80%98no-action-letter%E2%80%99-swaps-trading-eu-multilateral-trading-facilities>.

91. Press Release, U.S. Commodity Futures Trading Comm’n, The European Commission and the CFTC Reach a Common Path Forward on Derivatives (Jul. 11, 2014), available at <http://www.cftc.gov/PressRoom/PressReleases/pr6640-13>.

92. Press Release, Sec. Indus. & Fin. Mkts. Ass’n, SIFMA, ISDA and IIB File Lawsuit Challenging Commodity Futures Trading Commission’s Cross-Border Rule (Dec. 4, 2013), available at [http://www.sifma.org/newsroom/2013/sifma,-isda-and-iib-file-lawsuit-challenging-commodity-futures-trading-commission\\_s-cross-border-rule/](http://www.sifma.org/newsroom/2013/sifma,-isda-and-iib-file-lawsuit-challenging-commodity-futures-trading-commission_s-cross-border-rule/).

93. *Id.*; see generally Complaint, Sec. Indus. & Fin. Mkts. Ass’n v. Intl. Swaps & Derivatives Ass’n., No. 1-CV-1916 (ESH) (U.S. Dist. Ct. D.C.) (Dec. 27, 2013), available at [http://www.sifma.org/uploadedfiles/correspondence/legal\\_filings/2013/amendedcomplaint-as-filed-stamped.pdf?n=60168](http://www.sifma.org/uploadedfiles/correspondence/legal_filings/2013/amendedcomplaint-as-filed-stamped.pdf?n=60168).

the Guidance as well as to issue an injunction to prevent the CFTC from applying the Dodd-Frank Act's Title VII rules extraterritorially.<sup>94</sup> In addition, some of Wall Street's biggest lobbying groups are a part of SIFMA and a part of this lawsuit against the CFTC.<sup>95</sup> SIFMA represents Goldman Sachs Group Inc., JPMorgan Chase & Co., Deutsche Bank AG, and other swap dealers.<sup>96</sup>

Pursuant to the Administrative Procedural Act ("APA") and the CEA, the Plaintiffs to this lawsuit are challenging the Commission's promulgation of new regulations through the disguise of guidance.<sup>97</sup> The CEA requires the Commission to do a cost-benefit analysis for these new rules in light of: "(A) considerations of protection of market participants and the public; (B) considerations of the efficiency, competitiveness, and financial integrity of futures markets; (C) considerations of price discovery; (D) considerations of sound risk management practices; and (E) other public interest considerations."<sup>98</sup> The Supreme Court tends to defer to agencies and has imposed only minimum rule-making requirements;<sup>99</sup> when the statute in question allows for a cost-benefit analysis, the agency is allowed to use a cost-benefit analysis when considering a new rule.<sup>100</sup>

Additionally, the Plaintiffs are challenging numerous rules under the Dodd-Frank Act and the CFTC's failure to address how these rules would apply extraterritorially. Further, the Plaintiffs alleged that the CFTC cleverly promulgated binding cross-border rules through interpretive guidance.<sup>101</sup> Binding laws must go through adequate rulemaking procedures as delineated in section 553 of the APA.<sup>102</sup> It can be argued that the CFTC did not provide notice to foreign parties who are subject to the Guidance's regulations and are in violation of the APA's notice and comment requirements.

---

94. Complaint, *supra* note 93.

95. Silla Brush, Robert Schmidt, & Andrew Zajac, *Wall Street Trade Groups Sue U.S. CFTC Over Dodd-Frank Rules*, BLOOMBERG (Dec. 5, 2013, 12:03 PM), <http://www.bloomberg.com/news/2013-12-04/wall-street-trade-groups-sue-cftc-over-dodd-frank-rules-1-.html>.

96. *Id.*

97. Complaint at 1, Sec. Indus. & Fin. Mkts. Ass'n v. Intl. Swaps & Derivatives Ass'n., No. 1-CV-1916 (ESH) (U.S. Dist. Ct. D.C. (Dec. 27, 2013)), *available at* [http://www.sifma.org/uploadedfiles/correspondence/legal\\_filings/2013/amendedcomplaint-as-filed-stamped.pdf?n=60168](http://www.sifma.org/uploadedfiles/correspondence/legal_filings/2013/amendedcomplaint-as-filed-stamped.pdf?n=60168).

98. 7 U.S.C. § 19(a) (2010).

99. *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842–43 (1984) (establishing Chevron Two Step). Step one of the Chevron analysis is to determine whether the statutory language is ambiguous (or silent), or whether the meaning of the provision is clear using traditional tools of statutory construction. *Id.* If the meaning is clear, court will use the clear meaning of the statute; however, if the statute is ambiguous, one must proceed to step 2 of the analysis. Step 2 determines whether the agency's interpretation is reasonable or permissible, or if the interpretation is outside the range of ambiguity in the provisions. If the agency's interpretation is reasonable or permissible, the court upholds the agency's interpretation, even if the court does not believe it is the best interpretation. *Id.*

100. *Entergy Corp. v. Riverkeeper, Inc.*, 556 U.S. 208, 226 (2009) (deferring to the agency as to whether they may use a cost-benefit analysis; here, the EPA was allowed to rely on cost-benefit analysis in setting the national performance standards in providing for cost-benefit variances from those standards as part of the Phase II regulations).

101. See generally Complaint, Sec. Indus. & Fin. Mkts. Ass'n v. Intl. Swaps & Derivatives Ass'n., No. 1-CV-1916 (ESH) (U.S. Dist. Ct. D.C.) (Dec. 27, 2013), *available at* [http://www.sifma.org/uploadedfiles/correspondence/legal\\_filings/2013/amendedcomplaint-as-filed-stamped.pdf?n=60168](http://www.sifma.org/uploadedfiles/correspondence/legal_filings/2013/amendedcomplaint-as-filed-stamped.pdf?n=60168).

102. 5 U.S.C. § 553 (stating that informal rulemaking requires notice, comment, and concise general statements addressing the major comments).

On September 16, 2014, the Honorable Judge Paul Friedman granted the CFTC's motion to dismiss the Plaintiff's broad based challenge to Title VII Rules, but did remand those Rules to the CFTC for the costs and benefits of their extraterritorial applications.<sup>103</sup> Even with the remand, Judge Friedman chose not to invalidate the Rules during the remand period. The D.C. Court found the Cross-Border Action to be nothing more than a policy statement reflecting the CFTC's current views on a regulatory process.<sup>104</sup>

Historically, the D.C. Circuit has invalidated several SEC rulemaking procedures on the grounds of "inadequate consideration of economic consequences . . . and fail[ure] to respond to substantial problems raised by commenters."<sup>105</sup> The CEA requires similar economic and public interest considerations. The domestic and international pushback on the CFTC's implementation of Dodd-Frank's provisions reinforces this Article's proposal to pause and limit the Act's cross-border applications until harmonization has been achieved.

#### IV. Addressing the Critics

##### A. Diversity, and Not Harmonization, Will Optimize the Global Financial Structure

Uniformity can manage systemic risk, but a uniform regulatory structure is also insulated from competition from alternative approaches. Professor Sean J. Griffith of Fordham University School of Law argues against harmonization and uniformity because these principles will create a "fragile" structure.<sup>106</sup> He believes that "systems emphasizing uniformity and harmonization, however, are by definition not exposed to competition and therefore lack the fundamental capacity for trial and error necessary for learning and improvement."<sup>107</sup> As a result, when something unpredictable occurs, such as another financial crisis or "unpredictable shock," the harmonized system will be "ultimately doomed."<sup>108</sup> Professor Griffith also argues that diversity will optimize regulatory structure because it "seeks to guarantee the robustness of individual units within the system as a whole, but in order to avoid discouraging experimentation and innovation, does not insist that each unit within the system regulate risk the same way."<sup>109</sup>

Professor Griffith's argument does have some merits; however, his fears can easily be overcome. Applying Griffith's position to the U.S. legal system highlights

---

103. *Sec. Indus. & Fin. Mkts. Ass'n., et al., v. CFTC*, 13-CV-1916 slip op. (D.D.C. Sept. 14, 2014).

104. *Id.*

105. Dan M. Berkovitz, *The CFTC's Implementation of Financial Market Reform: Progress and Legal Challenges*, 34 NO. F. FUTURES & DERIVATIVES L. REP. 1, 4 (2014) (providing a description of cases against the SEC under the section entitled: Judicial Review of Agency Rulemakings).

106. Griffith, *supra* note 32, at 1345.

107. *Id.*

108. *Id.* at 1346; *see also* NASSIM NICHOLAS TALEB, *ANTIFRAGILE: THINGS THAT GAIN FROM DISORDER (INCERTO)* 11–12 (1st ed. 2012).

109. Griffith, *supra* note 32, at 1346 n.266 (stating that a "system of uniform regulation discourages experimentation and innovation by creating substantial barriers to the enactment of alternative regimes. . . . Faced with odds stacked against enactment, a would-be regulatory entrepreneur is less likely to invest in developing an alternative regime than they might otherwise").

the flaws in his premise. If harmonization leads to stagnation, then federal legislation would never change. However, this is not true—laws and legislation are constantly being challenged and updated in order to create a better legal framework. Similarly, having uniform cross-jurisdictional rules for regulating derivatives does not mean those rules are being carved into stone. Financial and business leaders will continue to optimize their businesses by lobbying policy makers for different regulations. Having harmonized regulations does not mean each country will forfeit their economic sovereignty, but instead their cross-border applications will not conflict with those of another jurisdiction.

#### B. The Cross-Border Application of the Dodd-Frank Act Is Necessary to Protect U.S. Taxpayers and Economy

One argument against pausing the implementation of the Dodd-Frank Act's extraterritorial reach, or limiting the act until harmonization can be achieved, is that the lack of regulation leaves the U.S. economy exposed. Professor Michael Greenberger argues that the extraterritorial scope of the Dodd-Frank Act is necessary to protect U.S. interests that are directly involved or threatened in order to "protect U.S. tax payers from the risks posed by the unregulated and interconnected global derivatives market."<sup>110</sup> Additionally, Professor Greenberger states that the extraterritorial scope of the Dodd-Frank Act would "improve the competitive position of U.S. financial institutions by restoring investor confidence in the U.S. derivatives market."<sup>111</sup>

It is true that the U.S. government spent billions of dollars during the 2008 financial crisis to bail out and prop up several financial institutions.<sup>112</sup> However, the G20, the Dodd-Frank Act, EMIR, and other domestic and international regulations are all aimed at reducing systematic risk in order to prevent another crisis similar to the 2008 crisis. This Article is not asserting that cross-jurisdictional rules from the Dodd-Frank Act are unnecessary; however an international effort is needed to ensure other issues such as regulatory arbitrage, high compliance burdens, and conflicts in law are avoided. Because the derivatives market is an international affair, it must be dealt with through international agreements.

In addition, domestic leaders are also hesitant about how far the CFTC's jurisdictional scope extends. As previously discussed, the CFTC chose to use an interpretive guidance to expand the Dodd-Frank Act's cross-border applications instead of formal rulemaking. The lack of harmonization has only lead to tension between the United States and the EU because the implementation deadlines have been almost impossible to meet.<sup>113</sup>

---

110. Michael Greenberger, *The Extraterritorial Provisions of the Dodd-Frank Act Protects U.S. Taxpayers From Worldwide Bailouts*, 80 UMKC L. REV. 965, 975 (2012).

111. *Id.*

112. *Id.* at 967.

113. Kentz, *supra* note 71 (noting Members of the European Parliament have asked U.S. regulators to recalibrate their approach in implementing global reforms in order to ensure a level playing field across jurisdictions).

Pausing or limiting the cross-border applications of the Dodd-Frank Act does not mean less protection for the U.S. taxpayer or economy, nor that is the goal to prevent another financial crisis by standardizing trading on regulated platforms forgotten. The United States and nineteen other countries at the G20 summits in London and Pittsburgh pledged to reform financial regulations, meaning the United States is not alone in trying to mitigate the risks of derivative trades.

## V. Proposals

As Professor Eric Pan concluded, “The cross boarder nature of many firms’ operations and their reach . . . demands cooperation and coordination between states and regions.”<sup>114</sup> The CFTC has felt tremendous pushback both domestically and internationally for the extraterritorial reach of the Dodd-Frank Act. There has been much confusion and adverse effects for some of the Act’s provisions including the margin requirement, the new swap execution facilities, and what will qualify for “substituted compliance.”

The CFTC must consider suspending the cross-border requirements until the United States can reach regulatory convergence with some of the major foreign players, such as the EU. Otherwise, regulatory arbitrage and increased compliance burdens from regulatory fragmentation are inevitable. Additionally, foreign leaders and the G20 should consider having a neutral governing body to oversee and regulate international disputes regarding derivative regulations.

### A. FSB to Determine Whether Substitute Compliance Is Appropriate and Decide If A Country’s Policies Are Going Too Far

The G20 created the Financial Stability Board (“FBS”) at its London summit in April 2009.<sup>115</sup> The purpose behind creating the FSB was to “coordinate at the international level the work of national financial authorities and international standard bodies [] in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies.”<sup>116</sup> Similar to the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO), the FSB is a great asset to help coordinate regulatory issues, help formulate standards and regulatory frameworks, monitory activities, and help implementation in member states.<sup>117</sup>

Currently, there are no real repercussions for noncompliance with FSB efforts and the board has no substantial penalty except to “name and shame” uncooperative

---

114. Pan, *supra* note 36, at 2.

115. *Charter*, FIN. STABILITY BD. art. 1, *available at* [http://www.financialstabilityboard.org/publications/r\\_090925d.pdf](http://www.financialstabilityboard.org/publications/r_090925d.pdf) (Listing members in Annex A) (last visited Aug. 20, 2015).

116. *Id.*

117. *See generally About the FSB*, FIN. STABILITY BD., <http://www.financialstabilityboard.org/about/> (last visited Aug. 20, 2015).

members.<sup>118</sup> This Article proposes that the FSB be granted authority to decide whether different jurisdictions have comparable regulations meeting the goals of the G20, instead of allowing the CFTC and other individual jurisdictions to decide individually when cross-border regulations apply and when substitute compliance is appropriate. Also, the FSB should create a dispute resolution system, similar to that of the WTO,<sup>119</sup> to resolve international discrepancies and provide teeth to the otherwise feeble FSB.

Moreover, as Edward F. Greene argues, the “FSB could provide a useful forum for fostering dialogue to develop consistent standards . . . such as when derivatives should be centrally cleared . . . [and] minimum standards for OTC transactions.”<sup>120</sup> It will be challenging to forge an international organization with power from the FSB, but it can be achieved through small steps. First the United States and the EU can form a bilateral agreement through the FSB and align their regulatory policies. Over time, multilateral agreements can begin to form until the FSB becomes an international organization similar in size to the WTO.

## B. Taking Baby Steps to Harmonization

It will take some time for an organization and structure such as the WTO to emerge and oversee financial regulations. However, smaller steps must be taken. The United States and the EU showed international comity by releasing Path Forward to show their cooperation. This could potentially evolve from mutual recognition to a bilateral agreement aligning the jurisdictions’ regulatory rules.

## VI. Conclusion

The extraterritorial application of the Dodd-Frank Act has been at the center of many international debates because it is so far the most aggressive set of regulations resulting from the G20 summit and there have been numerous implementation issues. For example, the broadly defined “U.S. person” enables the CFTC to subject many foreign parties to the CFTC’s rules. The absence of harmonization has caused conflicts between the United States and the EU, regulatory arbitrage, and adverse positions for U.S. entities and their

---

118. Edward F. Greene & Joshua L. Boehm, *The Limits of “Name-and-Shame” in International Financial Regulation*, 97 CORNELL L. REV. 1083, 1091 (2012). The FSB stated in its April 2011 progress report that “all but a few of the jurisdictions” contacted by the FSB “already demonstrated sufficiently strong adherence to the relevant standards or are implementing reforms to strengthen their adherence.” *Promoting Global Adherence to Regulatory and Supervisory Standards on International Cooperation and Information Exchange: Progress Report*, FIN. STABILITY BD. 3–4 (Apr. 29, 2011), available at [http://www.financialstabilityboard.org/publications/r\\_110429.pdf](http://www.financialstabilityboard.org/publications/r_110429.pdf). However, for the very small number of jurisdictions that have not “cooperated satisfactorily”, the FSB intended to publish their names. *Promoting Global Adherence*, *supra* note 118, at 3.

119. See *Understanding the WTO: Settling Disputes*, WORLD TRADE ORG., [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/displ\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/displ_e.htm) (last visited Aug. 20, 2015).

120. Edward & Potiha, *supra* note 69, at 42–43.

*Dodd-Frank Act and Cross-Border Applications*

counterparties.<sup>121</sup> Although the Dodd-Frank Act is a monumental step to providing more stability to the U.S. economy, it is also important for the U.S. to harmonize its regulations with other nations.

---

121. See *U.S. and EU OTC Derivatives Regulations – a Comparison of the Regimes*, SIDLEY AUSTIN LLP, 3–17 (Apr. 23, 2012), [http://www.sidley.com/~media/files/news/2012/04/us-and-eu-otc-derivatives-regulation-a-comparis\\_/files/view-update-in-pdf-format/fileattachment/derivatives-update204232012.pdf](http://www.sidley.com/~media/files/news/2012/04/us-and-eu-otc-derivatives-regulation-a-comparis_/files/view-update-in-pdf-format/fileattachment/derivatives-update204232012.pdf).

