



**Americans for Financial Reform**  
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## **STATEMENT FOR THE RECORD**

### **Agriculture Committee, Subcommittee on General Farm Commodities and Risk Management**

#### **“Dodd-Frank Derivatives Reform: Challenges Facing U.S. and International Markets”**

**December 13, 2012**

Today’s hearing deals with the question of the cross-border or extra-territorial application of the Dodd-Frank Act’s derivatives provisions. Americans for Financial Reform has previously commented on this issue in detail to the Commodity Futures Trading Commission (CFTC).<sup>1</sup> However, for the purposes of the hearing AFR would like to provide a summary of key points.<sup>2</sup>

Strong extra-territorial enforcement of derivatives reforms is absolutely central to protecting the U.S. economy and U.S. taxpayers from the risks of unregulated derivatives markets. In recent months, large international banks and in some cases foreign regulators have opposed effective cross-border application of U.S. derivatives regulation. In evaluating this opposition, several key points must be kept in mind:

- The largest global banks can shift derivatives risks and funding between thousands of international subsidiaries at the touch of a computer keyboard. It is therefore impossible to effectively regulate derivatives markets without applying rules to transactions conducted through foreign subsidiaries. Without cross-border applicability, there is no effective regulation of derivatives.
- Many non-U.S. jurisdictions, particularly in Europe, lag years behind the United States in implementing derivatives protections. Delaying the application of derivatives rules until they are completed in every jurisdiction could create an open-ended delay of multiple years in regulating U.S. derivatives markets. Four years after the financial crisis and two years after the passage of the Dodd-Frank Act, we cannot afford further multi-year delays in effectively regulating our financial markets.

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<sup>1</sup> See Americans for Financial Reform, “Comment Letter On The Cross-Border Applications of Certain Provisions of the Dodd-Frank Act”, August 27, 2012. Available at <http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2012/08/AFR-CFTC-Cross-Border-Comment-letter-8-27-12.pdf>

<sup>2</sup> AFR is a coalition of more than 250 national, state, local groups who have come together to advocate for reform of the financial sector. Members of the AFR include consumer, civil rights, investor, retiree, labor, religious and business groups along with prominent independent experts.

- The application of derivatives safeguards to the global operations of U.S. banks does not represent a competitive threat to the U.S. economy. Indeed, these safeguards will benefit the economy and taxpayers by preserving financial stability, and will reduce incentives for the outsourcing of U.S. jobs to foreign regulatory havens. The profits of Wall Street subsidiaries in London or Singapore must not be prioritized over the interests of U.S. taxpayers.

None of these points mean that regulators should not take reasonable and responsible steps to accommodate differences in international regulatory regimes. But cross-border issues must not become an excuse for disguised deregulation.

### **Without Cross-Border Applicability, There is No Effective Derivatives Regulation**

Modern financial markets are inherently global in scope. Profits and losses experienced in overseas affiliates return to affect the parent company and the U.S. economy.

We have learned this lesson in many crises, most recently in the massive derivatives losses experienced at JP Morgan's London office, and most painfully in the world financial collapse of 2008. Nowhere is the globalization of financial markets more evident than in the derivatives market. As CFTC Chair Gary Gensler has stated with respect to the extraterritoriality issue:

“Swaps executed offshore by U.S. financial institutions can send risk straight back to our shores. It was true with the London and Cayman Islands affiliates of AIG, Lehman Brothers, Citigroup and Bear Stearns. A decade earlier, it was true, as well, with Long-Term Capital Management. The nature of modern finance is that large financial institutions set up hundreds, if not thousands of “legal entities” around the globe... Many of these far-flung legal entities, however, are still highly connected back to their U.S. affiliates.”

Chairman Gensler's statements are confirmed by extensive experience and data. Bloomberg News has documented that large Wall Street banks routinely transact well over half of their swaps business through foreign subsidiaries.<sup>3</sup> Furthermore, these large institutions manage their revenues as integrated global entities, making little distinction based on the locations of gains and losses. As Professor Richard Herring of the Wharton School has stated:<sup>4</sup>

“Despite their corporate complexity, LCFIs [Large Complex Financial Institutions] tend to be managed in an integrated fashion along lines of business with only minimal regard

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<sup>3</sup> See Brush, Silla, “[Goldman Sachs Among Banks Lobbying To Exempt Half of Swaps From Dodd Frank](#)”, Bloomberg News, January 30, 2012.

<sup>4</sup> Page 217, Herring, R. and J. Carmassi, “The Structure of International Financial Conglomerates: Complexity and Its Implications for Systemic Risk,” Chapter 8 in the *Oxford Handbook of Banking*, edited by A. Berger, D. Molyneux, and J. Wilson, Oxford University Press, 2010.

for legal entities, national borders or functional regulatory authorities. Moreover, there are often substantial interconnections among the separate entities within the financial group.”

Exempting derivatives transactions conducted through international subsidiaries from Dodd-Frank requirements would make central derivatives reforms unenforceable. U.S. companies could simply route their derivatives transactions through foreign subsidiaries, evading regulation, and then transfer cash flows back to the U.S. parent company. Such transfers would be simple for the institutions, because as the above quote points out, major Wall Street banks are managed as global entities. It is well known and well documented that major banks, like other international corporations, manage liquidity on a global scale and freely move funding across borders in response to the needs of various subsidiaries and the home office.<sup>5</sup> Revenues from global subsidiaries are generally swept back to the central corporate treasury for distribution, often on a daily basis. Professor Herring has described how this process worked at Lehman Brothers, and how it complicated attempts at resolution of the bank:<sup>6</sup>

“But the fundamental problem was that LB [Lehman Brothers] was managed as an integrated entity with minimal regard for the legal entities that would need to be taken through the bankruptcy process. LBHI [Lehman Brothers Holdings, Incorporated] issued the vast majority of unsecured debt and invested the funds in most of its regulated and unregulated subsidiaries. This is a common approach to managing a global corporation, designed to facilitate control over global operations, while reducing funding, capital and tax costs....LBHI lent to its operating subsidiaries at the beginning of each day and then swept the cash back to LBHI at the end of each day.”

Exempting any of the subsidiaries of a global bank from derivatives oversight could thus effectively allow banks to avoid regulation on any derivatives transactions they chose. This would perpetuate the unregulated derivatives markets that were at the heart of the financial crisis, and undermine the core purposes of Title VII of the Dodd-Frank Act. The failure to properly enforce derivatives reforms internationally would expose U.S. taxpayers to the risks of a financial crisis triggered by unregulated derivatives activities conducted in foreign regulatory havens.

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<sup>5</sup> For one of many recent studies documenting this, see e.g. Cetorelli, N. and Goldberg, L., “[Banking Globalization, Monetary Transmission, and the Lending Channel](#)”, Forthcoming, *Journal of Finance*.

<sup>6</sup> Page 225, Herring, R. and J. Carmassi, “The Structure of International Financial Conglomerates: Complexity and Its Implications for Systemic Risk,” Chapter 8 in the *Oxford Handbook of Banking*, edited by A. Berger, D. Molyneux, and J. Wilson, Oxford University Press, 2010.

## **U.S. Rules Must Not Be Delayed Until The Rest of the World Has Equivalent Rules**

All of the G-20 nations have agreed in principle to a similar set of derivatives reforms, including requirements for central clearing, transparency, and exchange trading. In 2009 the G-20 nations jointly committed to implementing these reforms by the close of 2012.<sup>7</sup> Unfortunately, other countries lag well behind the United States in meeting that deadline. The latest reports from Europe are that implementation of European Union derivatives rules will be delayed until at least mid-2014.<sup>8</sup>

The CFTC has already proposed to delay extraterritorial application of many U.S. derivatives rules through mid-2013 in order to accommodate the concerns of foreign regulators. But creating further open-ended delays in U.S. derivatives rules will leave U.S. taxpayers exposed to risks taken in foreign subsidiaries of Wall Street banks for many years to come. Over two years have passed since the Dodd-Frank Act became law, and further delays in implementing derivatives rules are unacceptable. The effort to postpone full implementation of U.S. derivatives reforms until some indefinite date when other nations complete their rules is just the latest of a set of delaying tactics that have been used by large banks to prevent completion of financial reforms.

## **Timely Implementation of Derivatives Reforms Is Not A Threat to U.S. Competitiveness**

Some in the financial industry have argued that U.S. implementation of derivatives reforms is a threat to competitiveness. The claim is that foreign entities will refuse to engage in derivatives business with the foreign subsidiaries of U.S. banks if they know that such transactions will subject them to new requirements such as clearing, exchange trading, and capital requirements. In addition, foreign banks in Europe and other jurisdictions may refuse to do derivatives transactions with U.S. commercial counterparties if this would subject them to registration as a swaps dealer in U.S. markets.

These arguments are deeply misguided, for several reasons. First, they appear to prioritize the profits of financial entities located in foreign countries over the creation of U.S. jobs and the stability of the U.S. economy. It would be a grave error to expose the U.S. economy to the risk of financial instability simply so that the Singapore or London subsidiary of a Wall Street bank can do unregulated derivatives transactions with foreign counterparties. This is especially true since an exemption for foreign subsidiaries would tend to benefit the economy of the foreign jurisdiction where those subsidiaries are located at the expense of the United States. Likewise, creating exemptions that permit U.S. commercial counterparties to perform unregulated derivatives transactions with foreign banks would privilege those foreign banks above regulated US institutions.

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<sup>7</sup> See Financial Stability Board, "[Progress of Financial Regulatory Reforms](#)", April 16, 2012.

<sup>8</sup> Stafford, Phillip, "[Europe Dallies on Derivatives Regulation](#)", Financial Times, December 4, 2012.

Industry arguments also ignore the benefits of global leadership in derivatives reform. As discussed above, the major G-20 nations have all agreed to implement derivatives reforms similar to those proposed in the Dodd-Frank Act. While these reforms have been delayed in other nations, in the long term we can expect that they will eventually be implemented in most jurisdictions. As the global derivatives market transitions toward greater oversight, ensuring that U.S. companies have a head start and greater experience in complying with the rules should eventually result in a competitive advantage for U.S. firms. And in the case of any foreign jurisdictions which defy the G-20 consensus and refuse to implement derivatives reform, we should clearly act to prevent exposure of the U.S. financial system to unregulated transactions in these jurisdictions.

Finally, the argument ignores the potential competitive advantages to be gained by improving the stability and reliability of U.S. derivatives markets through new reforms. Derivatives reforms require better risk management and greater loss reserves. These changes will mean that U.S. banks will provide more protection and stability for derivatives counterparties and customers, which is a competitive advantage. The U.S. financial sector has gained its international reputation due to our global leadership in creating stable and transparent markets. Indeed, it was over 150 years ago that the U.S. pioneered the derivatives clearinghouse. This was a major positive innovation in establishing robust and valuable marketplaces for commodities as well as key financial markets. Although permitting regulatory loopholes such as extra-territorial exemptions may create short-term profits, in the long run the greatest threat to the U.S. competitive edge is a repetition of the deregulation that led to the disastrous financial crisis of 2008.

### **Any ‘Substituted Compliance’ Regime Must Ensure That Foreign Rules Are Truly Comparable To U.S. Rules**

The CFTC has indicated that it will permit ‘substituted compliance’ with U.S. derivatives rules. Under substituted compliance, foreign subsidiaries of U.S. banks (and in some cases subsidiaries of foreign banks dealing with U.S. persons) will be able to satisfy U.S. requirements by complying with the rules in their local jurisdiction.

The danger raised by substituted compliance is that banks may seek out locations where regulation is weak and then attempt to use the inadequate foreign regulations to satisfy U.S. requirements. This means that it is crucial that any substituted compliance regime be strictly limited to jurisdictions that have genuinely comparable rules to the U.S. both in nature and in enforcement. Otherwise, we will see the emergence of regulatory havens that play a role similar to the role the Cayman Islands and other offshore jurisdictions have played as tax havens. Unless it is backed up by a real and thorough process to determine genuine comparability between regulatory regimes, substituted compliance is simply a form of disguised deregulation.

Regulators must maintain a commitment to genuine comparability determination using a thorough process that carefully compares both the nature and enforcement of rules in foreign jurisdictions to those of the United States. Some in industry have called for a ‘principles based’ comparability procedure, where substituted compliance is permitted in any jurisdiction that has agreed in principle to oversee derivatives markets. Such calls for ‘principle based’ comparability are simply an effort at backdoor deregulation, as they do not ensure that regulations are genuinely equivalent.

Clearly there can be no substituted compliance until foreign jurisdictions actually complete and implement their rules. Foreign rules cannot be substituted for U.S. rules where foreign rules do not yet exist. As discussed above, foreign jurisdictions lag years behind the U.S. in implementing derivatives rules. The U.S. must therefore be prepared to implement derivatives reforms rapidly and institute any substituted compliance at a later date, once foreign governments have fully implemented their rules.

## **Following are the partners of Americans for Financial Reform.**

*All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.*

- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action
- Greenlining Institute
- Good Business International
- HNMA Funding Company
- Home Actions
- Housing Counseling Services

- Home Defender's League
- Information Press
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lake Research Partners
- Lawyers' Committee for Civil Rights Under Law
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Council of Women's Organizations
- Next Step
- OMB Watch
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network
- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group

- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalist for a Just Economic Community

*List of State and Local Affiliates*

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation (NY)
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK
- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville A
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY

- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG
- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- Neighborhood Economic Development Advocacy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis M
- North Carolina PIRG

- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center
- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

### *Small Businesses*

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Pheonix AZ
- The Holographic Repatterning Institute at Austin
- UNET

