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IN DEFENSE OF THE DEALERS: WHY THE SEC SHOULD ALLOW SUBSTITUTED COMPLIANCE WITH THE EUROPEAN UNION FOR SECURITY-BASED SWAP DEALERS

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Following the 2008–2009 financial crisis, legislators around the world enacted laws that regulated the over-the-counter (OTC) derivatives markets for the first time. These laws, though necessary, have duplicative requirements that dampen market efficiency. In the United States, the Securities and Exchange Commission is contemplating a "substituted compliance" regime with other jurisdictions. This regime would allow market participants to comply with one jurisdiction's requirements for certain transactions, rather than the requirements of multiple jurisdictions. This Note argues that the SEC should allow substituted compliance for OTC derivatives, but only for dealers located in the United States and European Union. Some advocate for a broader substituted compliance regime. These arguments, however, overlook nuances of the SEC's announced approach. Others argue that the SEC should avoid substituted compliance altogether. Ultimately, if the SEC allows substituted compliance narrowly and thoughtfully, it could preserve the economic benefits of a domestic financial market, while preventing some causes of the recent financial crisis.

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INTRODUCTION

On July 21, 2010, President Barack Obama explained to a crowd in the Ronald Regan building that the United States had recently "faced the worst recession since the Great Depression."[1] He was referring to the financial crisis of 2008–2009 ("financial crisis"), when "[t]ens of millions saw the value of their homes and retirement savings plummet" and countless businesses were unable to get the loans they needed, forcing many "to shut their doors."[2] Of course, the financial devastation was not contained to the United States, as people around the world suffered.[3] In the aftermath of the

1. President Barack Obama, Remarks on Signing the Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010), https://www.gpo.gov/fdsys/pkg/DCPD-201000617/pdf/DCPD-201000617.pdf [https://perma.cc/MN46-CVXA].

2. *Id.*

3. *See* Directorate-Gen. for Econ. & Fin. Affairs, European Comm'n, *Economic Crisis in Europe: Causes, Consequences and Responses*, EUR. ECON., Sept. 2009, at 1, 1 ("EU real GDP is projected to shrink by some 4% in 2009, the sharpest contraction in its history."); *see*

financial crisis, it became apparent that there was no singular cause.[4] Yet no group was more publicly vilified for its role than large financial companies.[5] Many companies had speculated with over-the-counter (OTC) derivatives.[6] They lost tremendous sums, while spreading financial damage through the interconnected global markets they had created.[7] President Obama cited a "failure of responsibility, from certain corners of Wall Street to the halls of power in Washington," as the primary cause of the financial crisis.[8]

In 2009, leaders from the G20[9] governments met to discuss the financial crisis and to create legislation that would both better regulate their financial markets and prevent another crisis.[10] Ultimately, they decided each jurisdiction would enact its own legislation based upon "shared policy objectives"[11] rather than a supranational approach by the entire G20.[12] In

also Inci Otker-Robe & Anca Maria Podpiera, *Seeing the Human Face of the Global Financial Crisis*, WORLD BANK: LET'S TALK DEV. (Nov. 4, 2013), http://blogs.worldbank.org/developmenttalk/seeing-human-face-global-financial-crisis [https://perma.cc/G6YM-BLCS].

4. *See Crash Course*, ECONOMIST (Sept. 7, 2013), http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-years-article [https://perma.cc/DBU6-LKGT].

5. *See, e.g.*, Zachary A. Goldfarb, *Goldman Sachs Executives Face Senators Investigating Role in Financial Crisis*, WASH. POST (Apr. 28, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/04/27/AR2010042702326.html ("It was a day of public flogging for Goldman Sachs.") [https://perma.cc/TKR5-WL9M].

6. Shah Gilani, *The Real Reason for the Global Financial Crisis . . . the Story No One's Talking About*, MONEY MORNING (Sept. 18, 2008), http://moneymorning.com/2008/09/18/credit-default-swaps/ [https://perma.cc/C5Q6-XZ7T]. Financial derivatives are instruments that derive value from the performance of an underlying asset, such as a stock or commodity. *See Financial Derivatives*, INT'L MONETARY FUND, http://www.imf.org/external/np/sta/fd/ (last visited Oct. 16, 2016) [https://perma.cc/278G-VFHX]. The sellers of OTC derivatives are referred to as "dealers," and typically purchasers are referred to as "end users." Sean J. Griffith, *Substituted Compliance and Systemic Risk: How to Make a Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291, 1298 (2014). Dealers and end users, together "counterparties," typically use derivatives as a form of hedging, or financial risk management. *Id.* at 1295 (describing derivatives as "a contractual means by which parties allocate the risk of a fluctuation in price of an underlying reference asset"); *see also The Mercatus Energy Pipeline: The Fundamentals of Oil & Gas Hedging—Swaps*, MERCATUS ENERGY ADVISORS (July 12, 2016) [hereinafter MERCATUS ENERGY ADVISORS], http://www.mercatusenergy.com/blog/bid/86598/The-Fundamentals-of-Oil-Gas-Hedging-Swaps (discussing the use of swaps, a form of OTC derivative, for hedging) [https://perma.cc/2AB5-UR4Q]. Some counterparties speculate with derivatives, however, to earn trading profits. *See* Gilani, *supra*.

7. *See* Gilani, *supra* note 6.

8. Obama, *supra* note 1.

9. *See generally* Jamil Mustafa, *What Is the G20 and How Does It Work?*, TELEGRAPH (Sept. 3, 2016, 10:47 AM), http://www.telegraph.co.uk/finance/g20-summit/5075115/G20-what-is-it-and-how-does-it-work.html [https://perma.cc/TMK9-PHS3]. The G20 members include Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom, the United States of America, and the European Union. *Id.*

10. *See generally* Leaders' Statement, G-20, The Pittsburg Summit 1 (Sept. 25, 2009), https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf [https://perma.cc/TY3W-TJXB].

11. *Id.* at 6.

the United States, this G20 commitment resulted in the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act[13] ("Dodd-Frank Act" or "Dodd-Frank").

The shared policy objectives of the G20 led to similar legislation across its jurisdictions, which in turn created an issue for buyers and sellers of OTC derivatives ("market participants").[14] During cross-border transactions, market participants must comply with legal requirements that are duplicative and not quite uniform, and the totality of compliance threatens to undermine the profitability of their OTC derivatives businesses.[15] The American agencies charged with regulating the OTC derivatives market under Dodd-Frank, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC or "the Commission"), then faced their own issue. They could maintain the new legal landscape for OTC derivatives, and potentially dampen the productivity of the American economy,[16] or they could grant some relief to the OTC derivatives industry, including many vilified financial companies, and hope that their actions would not result in another financial crisis.[17]

The CFTC chose to grant relief through "substituted compliance" determinations for eight foreign jurisdictions.[18] Substituted compliance allows certain sellers of OTC derivatives to satisfy American legal requirements by satisfying another jurisdiction's requirements.[19] In 2013, the SEC announced it would also consider a substituted compliance scheme, but to date it has not made any determinations.[20] This Note argues that the SEC should make a substituted compliance determination, allowing certain financial companies to substitute their compliance with European OTC derivatives laws for their compliance with equivalent American laws.[21] Though this would grant relief to financial companies partially responsible for the financial crisis, it is a compromise that addresses the legitimate issues these companies currently face, the intentions of the G20, and the purposes of Dodd-Frank, including protecting the financial markets and preventing another crisis.[22]

Part I of this Note provides a brief overview of the role of OTC derivatives in the financial crisis and the different approaches taken by the United States and the European Union to prevent a recurrence of the last crisis. Part II then outlines the arguments in favor and against a substituted compliance regime for the regulation of OTC derivatives. Finally, Part III proposes a method of substituted compliance for certain market participants

12. *See generally id.*
13. *See* Pub. L. No. 111-203, 124 Stat. 1376 (2010).
14. *See infra* Part II.
15. *See infra* Part II.
16. *See infra* Part II.
17. *See infra* Part II.
18. *See infra* Part I.B.1.
19. *See infra* Part I.B.1.
20. *See infra* Part I.B.3.
21. *See infra* Part III.
22. *See infra* Part III.

in a way that balances the risks, rewards, and goals of OTC derivatives regulation.

I. HOW THEY GOT TO SUBSTITUTED COMPLIANCE

Though dealers and end users, known collectively as counterparties, use OTC derivatives to mitigate risks, their speculative use by some counterparties, especially in cross-border transactions, contributed significantly to the financial crisis.[23] As discussed, the resulting legislation in G20 jurisdictions created cross-border issues that led to the crossroads the SEC faces regarding substituted compliance.[24] Part I.A begins with a summary of the role of OTC derivatives in the financial crisis. Part I.B surveys the legal responses to the financial crisis in the United States, beginning with the response of the CFTC and moving to that of the SEC. Finally, Part I.C surveys the European Union's legal response.

A. OTC Derivatives and Their Role in the Financial Crisis

OTC derivatives[25] are privately negotiated bilateral contracts that trade without an intermediary between the counterparties.[26] Historically, there was no centralized oversight of OTC derivatives markets and little government regulation,[27] as counterparties used OTC derivatives primarily to mitigate risks through hedging.[28] In the years leading up to the financial crisis, however, some large financial institutions in these decentralized and unregulated markets used substantial amounts of OTC derivatives to speculate.[29] These speculative derivatives predominantly had forms of credit as the underlying asset.[30] They included the "collateralized debt

23. *See infra* Part I.A.

24. *See infra* Part I.A–B.

25. The other broad category of derivatives is the exchange-traded derivative, which is highly standardized and traded through an intermediary. Griffith, *supra* note 6, at 1297–98. This Note does not focus on exchange-traded derivatives, as they were not a significant cause of the financial crisis. *See* Gilani, *supra* note 6.

26. Griffith, *supra* note 6, at 1298.

27. *See generally* Leaders' Statement, G-20, *supra* note 10.

28. *See, e.g.*, MERCATUS ENERGY ADVISORS, *supra* note 6.

29. *See* Gilani, *supra* note 6 (writing that the outstanding notional amount of one popular form of speculative OTC derivative was $62 trillion according to the International Swaps and Derivatives Association (ISDA)). As of 2011, the OTC derivatives market was estimated as exceeding $700 trillion of total notional amount, or $20 trillion if all transactions were settled simultaneously. John C. Coffee, Jr., *Extraterritorial Financial Regulation: Why E.T. Can't Come Home*, 99 CORNELL L. REV. 1259, 1272 n.38 (2014).

30. *See Crash Course*, *supra* note 4; *see also* Griffith, *supra* note 6, at 1304–06.

obligation"[31] (CDO) and a subform of the generic "swap,"[32] referred to as the "credit-default swap"[33] (CDS).

In the United States, financial firms purchased these credit derivatives with mortgages as the underlying form of credit.[34] When the American real estate bubble burst in 2008, borrowers defaulted on the mortgage payments underlying the derivatives, which led speculative purchasers to default on their payments to other counterparties.[35] Given the substantial speculative position of some financial institutions,[36] losses on credit derivatives rendered some of them insolvent and threatened the solvency of others.[37] This led to fears of runs on the financial institutions and, ultimately, to bailouts of some institutions by the federal government.[38]

Often, these credit derivatives were cross-border transactions,[39] which exposed American financial institutions to the credit risk of foreign counterparties and foreign counterparties to the risk of insolvent American institutions.[40] The market was interconnected globally.[41] Cross-border OTC derivatives were the lynchpin of a systemic risk that threatened a global financial contagion.[42]

The 2009 summit of G20 leaders was an attempt to address the structural issues stemming from the financial crisis, including those caused by OTC

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31. Griffith, *supra* note 6, at 1304–06.

32. In a "swap" derivative transaction, counterparties agree to exchange payments based on the value of an underlying asset over time. Griffith, *supra* note 6, at 1295. Swaps involve at least two risks: (1) the fluctuation in value of the underlying assets and (2) the possibility that one counterparty will become insolvent and fail to complete payment under the contract. *Id.* at 1300.

33. *See* Gilani, *supra* note 6. Counterparties agree to receive interest payments in exchange for insuring against the default of an underlying form of credit (typically a loan or bond). *See* Griffith, *supra* note 6, at 1298–99. However, counterparties do not need to lend the money for the underlying credit form; thus, CDSs allow counterparties to speculate on any form of credit more easily. *Id.*

34. Mortgages were pooled together for use in derivatives. *See Crash Course*, *supra* note 4; *see also* Griffith, *supra* note 6, at 1304–06.

35. *See, e.g.*, Adam Davidson, *The Big Money: How AIG Fell Apart*, REUTERS (Sept. 19, 2008, 10:27 AM), http://www.reuters.com/article/2008/09/19/us-how-aig-fell-apart-idUSMAR85972720080919 [https://perma.cc/X4CD-EAHY].

36. Griffith, *supra* note 6, at 1304 (describing the "overexposure" of financial institutions to housing through CDOs).

37. *See, e.g.*, Andrew Ross Sorkin, *Lehman Files for Bankruptcy; Merril is Sold*, N.Y. TIMES (Sept. 14, 2008), http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=all&_r=0 [https://perma.cc/MUA6-XGJS]. Issues over valuing credit derivatives also contributed to the losses and ultimate insolvency of financial institutions. *See* Griffith, *supra* note 6, at 1306.

38. *See* Griffith, *supra* note 6, at 1307; *see also* Gilani, *supra* note 6.

39. A cross-border transaction is between two counterparties in different jurisdictions. *See* 17 C.F.R. § 240.3a71-3 (2016).

40. *See, e.g.*, Coffee, Jr., *supra* note 29, at 1262 (discussing AIG's purchase of CDSs through a British subsidiary).

41. *See* GUILIO GIRARDI, CRAIG LEWIS & MILA GETMANSKY, SEC, INTERCONNECTEDNESS IN THE CDS MARKET 1 (2014), https://www.sec.gov/dera/staff-papers/white-papers/credit-defaul-swaps-interconnectivity-04-2014.pdf [https://perma.cc/TRW8-CAW4].

42. *See* Coffee, Jr., *supra* note 29, at 1262.

derivatives, and to prevent another crisis.[43] They agreed to not only regulate the OTC derivatives market within their home jurisdictions[44] but also to cooperate in regulating the global marketplace.[45] Legislation throughout the developed financial world ensued.[46]

B. Almost to Substituted Compliance: American Legal Responses to the OTC Derivatives Market Post-Financial Crisis

To realize the G20 goals for the OTC derivatives market, Congress enacted Title VII of Dodd-Frank,[47] which amended the Commodity Exchange Act[48] and the Securities Exchange Act.[49] Through Dodd-Frank, Congress split regulatory jurisdiction over derivatives between the CFTC and the SEC based on the underlying asset of the product.[50] The CFTC would have jurisdiction over swaps, while the SEC would have jurisdiction over "security-based swaps" (SBSs).[51] Because the SEC regulates the underlying securities, Congress granted oversight over SBSs to the SEC, rather than the CFTC.[52] Though swaps and SBSs are economically similar,[53] the split reflected the CFTC's and SEC's existing jurisdictional scopes.[54] Congress also mandated that the SEC and CFTC fully define the entities and transactions described in Title VII.[55]

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43. Leaders' Statement, G-20, *supra* note 10, at 7.

44. *Id.*

45. *Id.*

46. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); *Corporations Act 2001* (Cth) pt 7.5A (Austl.); Council Regulation 648/2012, 2012 O.J. (L 201) 1.

47. Pub. L. No. 111-203, tit. VII, 124 Stat. 1376, 1641–802 (2010).

48. 7 U.S.C. § 1(a) (2012).

49. 15 U.S.C. § 78c.

50. *See generally* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208 (Aug. 13, 2012) (to be codified at 17 C.F.R. pts. 230, 240, 241).

51. 15 U.S.C. § 78c(a)(68)(A) ("[T]he term security-based swap means any agreement, contract, or transaction that is a swap . . . under section 1(a) of the Commodity Exchange Act . . . and is based on . . . the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index.").

52. *See* 15 U.S.C. § 78c; *see also id.* § 78b ("[T]ransactions in securities as commonly conducted upon . . . over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions.").

53. *See Dodd-Frank Essentials for End Users of OTC Derivatives—Update 1*, SIDLEY AUSTIN LLP 1–2 (Aug. 17, 2010), http://www.sidley.com/~/media/Files/News/2010/08/What%20Is%20a%20Swap/Files/View%20Update%20in%20PDF%20Format/FileAttachment/investment%20funds%20update%2081710 [https://perma.cc/ZXE2-5JJJ]. Additionally, many large financial companies transact in both swaps and SBSs. *See, e.g.*, Don Thompson, *U.S. Financial Regulatory Reform and the Evolving OTC Landscape*, JP MORGAN (Jan. 17, 2012), https://www.jpmorgan.com/jpmpdf/1320605430085.pdf (discussing the regulatory differences between products) [https://perma.cc/M8XX-4LVX].

54. *See Derivatives*, SEC, https://www.sec.gov/spotlight/dodd-frank/derivatives.shtml (last modified May. 4, 2015) (stating that Congress included SBSs under the definition of security by amending the Securities Act of 1933 and the Securities Exchange Act of 1934) [https://perma.cc/W9RH-NFC2].

55. 15 U.S.C. § 8302(d)(1) (directing the CFTC and the SEC to further define the terms "swap," "security-based swap," and "swap dealer").

To fulfill their obligations under Dodd-Frank, the CFTC and SEC had to define the limits and requirements applicable to OTC derivatives counterparties and determine the operation of those requirements to counterparties during cross-border transactions.[56] Part I.B.1 below summarizes the CFTC's resulting regulatory scheme and cross-border approach. Part I.B.2 analyzes the SEC's regulations in-depth, while Part I.B.3 summarizes the SEC's application of its requirements to cross-border SBSs.

1. The CFTC's Regulations and Cross-Border Approach

Under Dodd-Frank, the CFTC eschewed formal rulemaking and adopted a regulatory framework through interpretive guidance and policy statements that created a set of responsibilities for swaps counterparties.[57] It then asserted a general policy that these requirements may apply to cross-border swaps with a "direct and significant connection with activities in, or effect on, commerce of the United States."[58] Though the application of these requirements would be flexible,[59] the CFTC intended to regulate cross-border transactions that posed risks to the U.S. economy.[60] The result of the CFTC's policy was that foreign counterparties often were subject to the CFTC's requirements when they transacted with American counterparties.[61]

The CFTC focused on harmonization with other regulators, as it recognized that the swaps market would be regulated for the first time.[62] This included consultation with the SEC "in an effort to increase understanding of each other's regulatory approaches and to harmonize the cross-border approaches of the two agencies."[63] The agencies' objective was to coordinate their cross-border approaches "to the greatest extent

56. *See infra* Part I.B.1–3.

57. *See generally* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,291 (July 26, 2013) (to be codified at 17 C.F.R. ch. 1). This framework includes numerous transaction-level and entity-level requirements for swaps counterparties. *See id.* Entity-level requirements apply to a firm as a whole, while transaction-level requirements apply to firms on a transaction-by-transaction basis. *See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations*, CFTC 1–2 http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/crossborder_factsheet_final.pdf (last visited Oct. 16, 2016) [https://perma.cc/6BHT-QNG9].

58. *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. at 45,297.

59. *See id.* ("Unlike a binding rule adopted by the Commission . . . this Guidance is a statement of the Commission's general policy . . . and allows for flexibility in application to various situations, including consideration of all relevant facts and circumstances.").

60. *See id.* at 45,295 (stating that the vulnerabilities stemming from the interconnected global swaps market in part demonstrates the need for cross-border swaps regulations); *see also* Edward F. Greene & Ilona Potiha, *Examining the Extraterritorial Reach of Dodd-Frank's Volcker Rule and Margin Rules for Uncleared Swaps—A Call for Regulatory Coordination and Cooperation*, 7 CAP. MARKETS L.J. 271, 275–78 (2012).

61. *See* Greene & Potiha, *supra* note 60, at 282.

62. *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. at 45,296. The CFTC also acknowledged "many jurisdictions are in differing stages of implementing their regulatory reform." *Id.*

63. *See id.*

possible."[64] This objective was, however, neither required nor binding on either agency.[65] The CFTC also coordinated with international regulators before releasing its cross-border guidance.[66]

In pursuit of global harmonization, the CFTC instituted a substituted compliance regime.[67] Substituted compliance allows foreign counterparties in cross-border transactions to satisfy CFTC regulatory requirements by satisfying their home jurisdiction's regulatory requirements.[68] As part of this regime, the CFTC issued informal comparability determinations between its regulatory requirements and those of foreign jurisdictions.[69] Regulators in the United States had narrowly used substituted compliance before,[70] so the CFTC's determinations were not novel.[71] The CFTC intended its framework to allow foreign regulators latitude for their regulatory interests[72] and to mitigate the burdens of conflicting or duplicative regulations for non-U.S. counterparties.[73] Substituted compliance would not, however, compromise "the high level of regulation contemplated by the Dodd-Frank Act" to protect the United States from another financial crisis.[74]

2. The SEC's Regulations In-Depth

Pursuant to its rulemaking authority under Dodd-Frank, the SEC implemented regulations for SBSs similar to those of the CFTC for

64. *Id.*

65. *Id.* (acknowledging the differences between the two agencies' approaches).

66. *Id.* (recognizing that, in the highly interconnected derivatives market, "risks are transmitted across national borders and market participants operate in multiple jurisdictions").

67. *See Comparability Determinations for Substituted Compliance Purposes*, CFTC (Dec. 27, 2013), http://www.cftc.gov/LawRegulation/DoddFrankAct/CDSCP/DoddFrankCDF5 [hereinafter CFTC, *Comparability Determinations*] [https://perma.cc/YY9C-V5HV].

68. *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. at 45,340. Foreign counterparties and regulators are eligible to apply for substituted compliance determinations by the CFTC. *Id.* at 45,344. The CFTC analyzes the applicable foreign laws and regulations to determine potential equivalency before granting substituted compliance for a jurisdiction or counterparty. *Id.*

69. *See, e.g.*, Comparability Determination for the European Union: Certain Transaction-Level Requirements, 78 Fed. Reg. 78,878 (Dec. 27, 2013).

70. *See, e.g.*, Greene & Potiha, *supra* note 60, at 310–11. In 2008, the SEC and an Australian regulatory agency implemented substituted compliance for certain stock exchanges and broker-dealers in each country to operate without having to comply with duplicative regulations. *Id.*

71. In 2013, the CFTC made eight equivalency determinations for other jurisdictions, including for both entity and transaction-level requirements in the European Union. *See* CFTC, *Comparability Determinations*, *supra* note 67. This was a series of "broad comparability determinations." *Id.*

72. *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. at 45,301, 45,340–41.

73. *See id.* at 45,340–41.

74. *See id.* at 45,340.

swaps.[75] Like the CFTC, the SEC requires counterparties to register with it,[76] report information to data repositories,[77] and maintain minimum levels of capital[78] and margin.[79] The reporting, recordkeeping, capital, and margin requirements are analyzed below.

a. Capital and Margin Requirements

Of the requirements mandated by Dodd-Frank, and derivatives regulations globally, capital and margin requirements are especially important to commenters.[80] Independent "third-party custodian[s]" hold the capital and margin funds that counterparties allocate for SBSs in segregated accounts.[81] The more counterparties allocate funds to satisfy these requirements, the fewer funds they have to complete new SBS transactions.[82] Therefore, duplicative capital and margin requirements can

75. *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, SEC, http://www.sec.gov/spotlight/dodd-frank.shtml (last modified July 7, 2016) [https://perma.cc/F72R-CJAQ].

76. *See e.g.*, 17 C.F.R. § 240.15Fb2-1 (2016) (requiring all counterparties to register with the SEC as either "security-based swap dealers" or "major security-based swap participants"); *id.* § 242.901 (listing the reporting obligations of counterparties involved in SBS transactions). There are de minimis thresholds for registration with the Commission, and, therefore, only dealers and market participants who trade in significant amounts are subject to the full panoply of SEC regulations. *Fact Sheet: Defining Swaps-Related Terms*, SEC, http://www.sec.gov/News/Article/Detail/Article/1365171492905 (last modified July 29, 2014) [https://perma.cc/7YJ7-3X3T].

77. *See infra* Part I.B.3.

78. *See* Capital requirements are funds specifically designated as a cushion to protect against runs by creditors in the event a financial firm's assets decline or its liabilities rise. DOUGLAS J. ELLIOTT, BROOKINGS INST., A PRIMER ON BANK CAPITAL (2010), http://www.brookings.edu/~/media/research/files/papers/2010/1/29-capital-elliott/0129_capital_primer_elliott.pdf [https://perma.cc/9WAP-VXGK].

79. Margin requirements are funds that counterparties must maintain on deposit in their accounts for individual trades. *See Maintenance Margin Requirement*, NASDAQ, http://www.nasdaq.com/investing/glossary/m/maintenance-margin-requirement (last visited Oct. 16, 2016) [https://perma.cc/V4CL-WE36].

80. *See* Reopening of Comment Periods for Certain Rulemaking Releases and Policy Statement Applicable to Security-Based Swaps, Exchange Act Release No. 34-69,491, 106 SEC Docket 1080 (Feb. 11, 2014). The SEC has reopened the comment period for the rules as of fall 2016. *Id.* The Commission originally proposed capital and margin requirements for SBS counterparties in November of 2012. *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70,214 (proposed Nov. 23, 2012) (to be codified at 17 C.F.R. pt. 240).

81. 15 U.S.C. § 78c-5(f)(3) (2012).

82. *See* ELLIOT, *supra* note 78; *see also Maintenance Margin Requirement*, *supra* note 79. The prudential regulators, which include the Federal Reserve Board, also have regulatory interest in the capital of SBS dealers. *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. at 70,217 ("The Commission staff consulted with the prudential regulators."). Though the requirements of these regulators affect the capital of SBS dealers indirectly, *see* Greene & Potiha, *supra* note 60, at 276, these effects are outside the scope of this Note.

be administratively inconvenient and profit suppressing for counterparties.[83]

The SEC's capital and margin requirements for SBSs are proposed but not finalized.[84] Under the proposed capital rules, SBS dealers would be subject to a separate rule, not applicable to other securities dealers, that would protect customer assets and mitigate the risks of counterparty failure while allowing firms flexibility in how they conduct business.[85] This standalone rule would impose a "net liquid assets" test on all SBS dealers, requiring the dealers to maintain a minimum level of net capital at all times.[86] More generally, the capital rules impose substantially higher minimum capital requirements for SBS dealers because the use of internal models for proprietary transactions can "substantially reduce" some standardized deductions prescribed by the rules.[87] The Commission is especially concerned with the ways SBS dealers value their transactions and prescribe capital based off these valuations because of risks that the SBS dealers will fail to properly value transactions.[88] There are also higher minimum requirements for dealers who engage in brokerage activities, as compared to those who engage solely in dealing, because of the substantial increase in importance and risk of brokerage activities in the securities market.[89]

For its SBS margin requirements, the SEC also based its approach off of preexisting broker-dealer requirements.[90] The Commission acknowledged it was imposing margin requirements on OTC SBS dealers for the first

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83. *See* Greene & Potiha, *supra* note 60, at 300 n.130.

84. *See supra* note 80 and accompanying text.

85. *See* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. at 70,218.

86. *Id.* at 70,219 ("This standard is designed to promote liquidity; the rule allows a broker-dealer to engage . . . in a manner that places the firm in the position of holding at all times more than one dollar of highly liquid assets for each dollar of unsubordinated liabilities (e.g., money owed to customers, counterparties, and creditors)."). Net capital is highly liquid capital, reserves of cash, or liquid securities. *Id.* The net capital test requires the dealer to determine how much net capital it must maintain over how much it is maintaining. *Id.* The minimum amount of net capital is the "greater of a fixed-dollar amount specified in the rule and an amount determined by applying one of two financial ratios," either a fifteen-to-one aggregate debt to net capital ratio or a 2 percent of aggregate debit items ratio. *Id.* In computing net capital, dealers also would have to make a number of adjustments and deductions, including taking prescribed percentage deductions from mark-to-market proprietary positions that are included in its tentative net capital. *Id.*

87. *Id.*

88. *Id.* Since dealers have an important position in the SBS market, and, therefore, have an increased capacity for perpetuating systemic market risk, they are subject to a more stringent net liquid asset test than other market participants. *Id.* at 70,220 (discussing test for MSBSPs).

89. *Id.* at 70,228 (stating that broker-dealers are important intermediaries and that their internal models are more risk sensitive, but may not capture all risks). For those dealers who engage solely in dealing, there is a $20 million fixed dollar minimum and $100 million tentative net capital requirement, as compared to a $1 billion fixed dollar minimum and $5 billion tentative net capital requirement for dealers who also engage in brokerage activities. *Id.* at 70,220.

90. *See id.* at 70,259.

time.[91] Under these rules, counterparties would have to maintain a specified level of their transacting partner's equity in a securities account, which they could liquidate to satisfy obligations in instances of nonpayment.[92] The amount of required funds depends on the nature of the transaction and its accompanying risk.[93]

b. Reporting and Recordkeeping Requirements

The SEC announced a number of significant reporting and recordkeeping requirements for SBS counterparties in a 2013 release,[94] some of which were adopted in Regulation SBSR.[95] Under these requirements, a counterparty must establish, document, and maintain a comprehensive "system of internal risk management controls to assist in managing the risks associated with its business."[96] They must also implement internal systems and controls that establish and enforce procedures to obtain any necessary information to perform required functions under the Securities Exchange Act and provide this information to the SEC.[97]

Building off of these requirements, the SEC requires that counterparties keep books and records of all activities related to their SBS business and report these books and records to the Commission.[98] In addition to reporting, counterparties must keep their books and records open to the SEC for inspection and examination,[99] exercise diligent supervision,[100] and ensure there are no conflicts of interest with their clients.[101] They must also have a chief compliance officer and adhere to licensing requirements and

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91. *Id.* at 70,258 (stating that there would be margin requirements for all SBSs that are not cleared). Under Dodd-Frank, the Commission will impose initial and variation margin. *Id.* The initiative was to address the fact that some dealers "experienced large uncollateralized exposures to counterparties experiencing financial difficulty, which, in turn, risked exacerbating the already severe market dislocation" during the financial crisis. *Id.*

92. *Id.* at 70,259.

93. *Id.*

94. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30,968 (proposed May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, 249).

95. *See* Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, 80 Fed. Reg. 14,740 (proposed Mar. 19, 2015) (to be codified at 17 C.F.R. pt. 242).

96. Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 31,013. These risk management systems would require counterparties to formally document trades. *Id.*

97. *See id.* at 31,013–14.

98. *See id.* This includes daily trading records, terms and conditions of SBSs, SBS trading operations, mechanisms and practices, financial integrity protections, and other relevant information. *See id.* at 31,013.

99. *See id.* at 31,015.

100. *See id.* at 31,014.

101. *See id.* ("Such policies and procedures must establish structural and institutional safeguards to ensure that the activities of any person within the firm relating to [SBSs] . . . are separated by appropriate informational partitions.").

statutory disqualifications.[102] Finally, the SEC has "external business conduct standards"[103] and requires the segregation of client assets by counterparties.[104]

3. The SEC's Cross-Border Approach

As the CFTC decided with swaps,[105] the SEC elected to subject any transactions involving an American counterparty to the above requirements for its cross-border approach.[106] Therefore, when transacting with American counterparties, foreign SBS counterparties had to comply with SEC requirements.[107]

The Commission stated this approach was "grounded in the text of" Dodd-Frank[108] but also acknowledged that "cross-border transactions are the norm, not the exception."[109] Under the SEC's cross-border approach, foreign counterparties transacting in the United States, and American counterparties transacting abroad, faced potentially duplicative requirements if another jurisdiction's requirements were equivalent to those of the SEC.[110] Duplicative requirements, again, can impair business

102. *Id.* at 31,014–15. Licensing requirements and statutory disqualification prevent potential abuse of SBSs by those already disqualified from the industry by statute. *See id.* at 31,015.

103. *Id.* at 31,010. These standards require that SBS dealers "(i) [v]erify that a counterparty meets the eligibility standards for an ECP; (ii) disclose to the counterparty material information about the security-based swap . . . ; and (iii) provide the counterparty with information concerning the daily mark for the security-based swap." *Id.*

104. *See id.* (stating that "segregation requirements are designed to identify and protect customer property" that SBS counterparties hold as collateral).

105. *See supra* Part I.B.1.

106. *See* Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. 47,278 (Aug. 12, 2014) (to be codified at 17 C.F.R. pts. 240, 241, 250) ("[I]t is appropriate to impose the statutory requirements, and rules or regulations thereunder, on security-based swap activity occurring within the United States even if certain conduct in connection with the security-based swap also occurs in part outside the United States."); *see also* Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent, 80 Fed. Reg. 27,444 (proposed May 13, 2015) (to be codified at 17. C.F.R. pts. 240, 242) (defining which types of transactions and counterparties are within the SEC's jurisdiction).

107. *See, e.g.*, Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. at 47,301 (allowing for the de minimis exception, but requiring registration by non-U.S. dealers); *see also* Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 80 Fed. Reg. at 27,444.

108. *See* Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. at 47,287.

109. Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 30,976.

110. *Id.* at 30,974.

efficiency.[111] Therefore, the Commission announced that it would consider adopting its own substituted compliance framework to address this issue.[112]

At adoption of its cross-border guidance, however, the Commission stated, "we expect to address issues regarding the availability of substituted compliance as part of future rulemakings" in conjunction with the cross-border application of specific rules.[113] It had previously listed the necessary Title VII requirements for a substituted compliance determination.[114] In its proposed capital and margin guidance, the Commission did not mention substituted compliance,[115] but it has addressed the topic in subsequent releases.[116]

Though it reviewed the CFTC's substituted compliance scheme,[117] the SEC ultimately decided it would only allow substituted compliance in a different form.[118] It would not complete a rule-by-rule comparison against

111. *See supra* notes 80–83 and accompanying text.

112. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 31,085. The Commission only provided guidance and procedures for substituted compliance of SBS dealers, not major SBS participants. *Id.* at 31,088–89.

113. Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. at 47,358. The Commission did adopt a procedural rule for foreign jurisdictions to apply for substituted compliance determinations. *Id.*

114. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 31,088–90. The requirements the Commission listed are those requirements described in Part I.B.2.

115. *See generally* Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70,214 (proposed Nov. 23, 2012) (to be codified at 17 C.F.R. pt. 240). The SEC expects to address the availability of substituted compliance for specific requirements in each requirement's rulemaking. *See supra* note 113 and accompanying text. Thus, the Commission will most likely address the potential for substituted compliance in its final capital and margin guidance. For the purposes of this Note, however, the proposed rules are used to assess the SEC's position on these requirements.

116. *See* Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information, Exchange Act Release No. 34-74,244, 2015 WL 1266798, at *152 (Feb. 11 2015) [hereinafter Regulation SBSR Release No. 34-74244] ("The Commission may issue a substituted compliance determination if it finds that the corresponding requirements of the foreign regulatory system are comparable to the relevant provisions of Regulation SBSR. . . . The availability of substituted compliance is designed to reduce the likelihood of cross-border market participants being subject to potentially conflicting or duplicative reporting requirements.").

117. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 31,097.

118. *Id.* at 31,088. Instead of providing informal interpretive guidance like that of the CFTC, *see supra* Part I.B.1, the SEC would undertake formal rulemakings to determine the availability of substituted compliance generally and whether specific jurisdictions would qualify for it. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 31,087–88. The Commission may only allow substituted compliance after it determines that foreign requirements are "comparable" to those of the SEC, *id.* at 30,088, and are accompanied by effective supervisory and enforcement programs, *id.* at 31,088 n.1119. It also would require

other jurisdictions' regulations.[119] The Commission stated it would focus on "regulatory outcomes as a whole."[120] Using its "holistic," "outcomes-based" approach, the Commission would have to conclude that another jurisdiction had the "reporting of data elements comparable to those required" by the Commission.[121] It did not, however, assess the equivalence of any foreign SBS regulations to its own.[122] Currently, it has neither made any substituted compliance determinations nor declared whether it will make any determinations.[123]

C. The European Legal Response to OTC Derivatives After the Financial Crisis

The European Union, unlike the United States, regulated a small portion of the OTC derivatives market prior to the financial crisis through its Directive on Markets in Financial Instruments (MiFID 1).[124] In 2012, however, the European Union enacted the European Markets Infrastructure Regulation (EMIR) to focus on OTC derivatives pursuant to the 2009 G20 agreements,[125] along with three directives specifically focused on OTC derivatives.[126] EMIR implemented several requirements, including information and recordkeeping requirements.[127] In 2013, a regulation[128]

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a Memorandum of Understanding regarding the foreign jurisdiction's supervisory and enforcement programs. *Id.*

119. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 31,085.

120. *Id.*

121. Regulation SBSR Release No. 34-74244, *supra* note 116, at *168. There is also an element of practicality in the Commission's approach. Given the complexity of American and foreign laws, there will inevitably be differences in any comparison. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 31,085. An outcomes-based approach, as the Commission views it, would be the most efficient approach to achieving the goals of Dodd-Frank. *See id.* at 31,085–86.

122. *See generally id.*

123. *See generally* Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent, 80 Fed. Reg. 27,444 (proposed May 13, 2015) (to be codified at 17. C.F.R. pts. 240, 242) (stating that certain counterparties would be eligible for substituted compliance if a determination were made).

124. *See* Council Directive 2004/39, art. 40, 2004 O.J. (L 145) 1, 28.

125. *See* Council Regulation 648/2012, 2012 O.J. (L 201) 1, 1.

126. Commission Implementing Regulation 1247/2012, 2012 O.J. (L 352) 20; Commission Delegated Regulation 148/2013, 2013 O.J. (L 52) 1; Commission Delegated Regulation 149/2013, 2013 O.J. (L 52) 11. In the European Union, member states must implement regulations uniformly, however, they have varying degrees of discretion when implementing directives, depending on the specific directive. *See* DELOITTE, CFTC AND EU OTC DERIVATIVES REGULATION: AN OUTCOMES-BASED COMPARISON 5 n.7 (July 2013), http://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-fs-cftc-and-eu-otc-derivatives-regulations.pdf [https://perma.cc/VRR8-SN2X].

127. *See infra* Part I.C.2. These were similar to SEC requirements, for example the reporting of counterparty data to repositories. *See, e.g.*, Council Regulation 148/2013, art. 1, annex, 2013 O.J. (L 52) 1, 2, 4 tbl.1.

and a directive[129] created counterparty capital requirements.[130] The European Union later amended EMIR through a regulation known as "MiFIR,"[131] and then enacted "MiFID 2,"[132] a companion directive to MiFIR that goes into effect January 3, 2018.[133] Finally, there are proposed regulatory technical standards for counterparty margin requirements under EMIR.[134]

Pursuant to the 2009 G20 Summit, these European regulations and directives established a framework for OTC derivatives dealers similar to regulatory frameworks enacted in the United States as a result of Dodd-Frank.[135] Furthermore, regulators in the United States and European Union discussed their OTC derivatives frameworks as the process unfolded.[136]

As discussed in Part I.B.3, to allow substituted compliance, the SEC must find the laws of a foreign jurisdiction equivalent to the requirements described in Part I.B.2. To that end, Part I.C.1–2 summarize the European regulations and directives that the SEC would analyze for a substituted compliance determination. As with the SEC's regulations in Part I.B.2, Part I.C.1 summarizes the European capital and margin requirements first, while Part I.C.2 summarizes the remaining requirements.

1. Capital and Margin Requirements

The European Union recently proposed new margin requirements for OTC derivatives in a public consultation.[137] Therefore, between the United States and the European Union, the European capital requirements are the only enacted laws or regulations for either capital or margin.[138]

However, these requirements are similar to the SEC's proposed capital requirements in that they require counterparties maintain a minimum level

128. Council Regulation 575/2013, 2013 O.J. (L 176) 1.

129. Council Directive 2013/36, 2013 O.J. (L 176) 338.

130. *See* ELLIOT, *supra* note 78 (discussing nature of capital requirements).

131. *See* Council Regulation 600/2014, 2014 O.J. (L 173) 84.

132. *See* Council Directive 2014/65, 2014 O.J. (L 173) 349.

133. *Updated Rules for Markets in Financial Instruments: MiFID 2*, EUR. COMMISSION, http://ec.europa.eu/finance/securities/isd/mifid2/index_en.htm (last visited Oct. 16, 2016) [https://perma.cc/4W4X-779U].

134. *See ESAs Consult on Margin Requirements for Non Centrally Cleared Derivatives*, EUR. BANKING AUTHORITY (June 10, 2015), https://www.eba.europa.eu/-/esas-consult-on-margin-requirements-for-non-centrally-cleared-derivatives [https://perma.cc/WU53-4XGR].

135. *See* DELOITTE, *supra* note 126.

136. *See* Joint Statement, United States (U.S.)—European Union (EU) Financial Markets Regulatory Dialogue (Jan. 30, 2014) [hereinafter Joint Statement], http://ec.europa.eu/finance/general-policy/docs/global/140129_us-eu-joint-statement_en.pdf [https://perma.cc/H249-TQWY]. Regulators from both jurisdictions stressed the importance of implementing the G20 commitments for OTC derivatives and minimizing divergences, as well as the need to consult with each other. *Id.*

137. *See supra* note 134 and accompanying text.

138. *See* Council Regulation 575/2013, 2013 O.J. (L 176) 1; Council Directive 2013/36, 2013 O.J. (L 176) 338.

of net capital in a standalone rule.[139] They also bring the capital requirements in line with the Basel Accords, which generally require financial firms to maintain higher levels of capital.[140] Additionally, the E.U. laws focus on the risks associated with the use of internal models[141] and prudent valuation of transactions overall.[142] In its proposed margin consultation, the European Union acknowledged it would be introducing margin requirements for OTC derivatives.[143] It also described the different forms of collateral available, and it stated the importance of risk management for its margin requirements.[144]

2. Remaining Requirements

The European Union's risk management systems provisions are located in articles 9 and 11 of EMIR,[145] article 16 of MiFID 2,[146] and Regulation 1247 of 2012.[147] There are numerous provisions for internal systems and control mechanisms as well.[148] As for SBS books and records, the European Union requires counterparties to maintain that information through EMIR,[149] three other regulations,[150] and MiFIR.[151] Counterparties

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139. *See* Council Regulation 575/2013, art. 412, 2013 O.J. (L 176) 1, 240. This requirement differs from the American capital requirements in that counterparties need not keep their capital funds in third-party accounts. *See* 15 U.S.C. § 78c-5(f)(3) (2012). However, counterparties in Europe must still hold the funds and cannot trade with them. *See* Council Regulation 575/2013, art. 412, 2013 O.J. (L 176) 1, 240. Despite the difference, therefore, a duplicative result is created between the two schemes. *See id.*

140. *See* Council Regulation 575/2013, art. 500, 2013 O.J. (L 176) 1, 284.

141. *See id.* art. 221, at 138.

142. *See id.* art. 105, at 71.

143. *See ESAs Consult on Margin Requirements for Non Centrally Cleared Derivatives*, *supra* note 134.

144. *See id.*

145. *See* Council Regulation 648/2012, art. 9, 2012 O.J. (L 201) 1, 20–21 ("Counterparties . . . shall ensure that the details of any derivative contract they have concluded . . . are reported to a trade repository."); *see also id.* art. 11, at 22 ("Financial counterparties . . . that enter into an OTC derivative contract not cleared by a CCP, shall ensure, exercising due diligence, that appropriate procedures . . . are in place to measure, monitor and mitigate operation risk and counterparty credit risk."). Article 11 also requires timely confirmation of OTC derivatives contracts and formalized processes to manage risks and disputes between parties. *See id.*

146. *See* Council Directive 2014/65, art. 13, 2014 O.J. (L 173) 349 (stating that firms shall maintain effective approval processes, regularly review products that could affect the potential risk to markets, and make all appropriate product information available).

147. *See* Council Regulation 1247/2012, 2012 O.J. (L 352) 20 (providing a detailed explanation, including trade details and other information counterparties must monitor for their OTC derivatives).

148. *See* Council Regulation 648/2012, art. 9, 2012 O.J. (L 201) 1, 20 (stating that trade information must be available to E.U. regulators); *see also id.* art. 11, at 22 (stating that financial counterparties shall ensure that procedures and arrangements are in place to measure, monitor, and mitigate operational and counterparty credit risk); Council Regulation 1247/2012, 2012 O.J. (L 352) 20 (stating that pertinent trade information be documented).

149. *See* Council Regulation 648/2012, arts. 9, 11, 2012 O.J. (L 201) 1, 20–22.

150. *See* Council Regulation 148/2013, art. 1, annex, 2013 O.J. (L 52) 1, 2, 4 tbl.1 (setting out details counterparties must provide for trade repositories); Commission Delegated Regulation 149/2013, 2013 O.J. (L 52) 11 (mandating that OTC derivatives be confirmed electronically to provide adequate records and access to the information); Council

must also keep their books and records open to regulators for inspection and examination.[152] The SEC requires that counterparties exercise diligent supervision.[153] Counterparties in the European Union must "establish, maintain, and enforce a system to supervise . . . diligently[] its business and its associated persons"[154] through applicable E.U. laws.[155] Articles 16.3 and 23 of MiFID 2 further mandate that counterparties take care to avoid conflicts of interest.[156]

MiFID 2 also requires that the managers of counterparties define and oversee "the implementation of the governance arrangements that ensure effective and prudent management" of the firm, and that management be involved in compliance issues.[157] Regulatory agencies in the European Union also reserve the right to refuse authorization for members of management to work if they are not of sufficiently good repute, or do not possess sufficient knowledge and experience, among other qualifications.[158] Finally, under article 16 of MiFID 2, counterparties in the European Union are required to protect clients, make information available to them regarding their transactions, and separate client assets from their own accounts.[159] These are similar to the SEC's two transaction-level

Regulation 1247/2012, 2012 O.J. (L 352) 20 (mandating that OTC derivatives be reported on a daily basis).

151. Council Regulation 600/2014, art. 25, 2014 O.J. (L 173) 84, 118 ("Investment firms shall keep at disposal of the competent authority, for five years, the relevant data relating to all orders and transactions which they have carried out.").

152. *See* Council Directive 2014/65, art. 16, 2014 O.J. (L 173) 349, 397 ("An investment firm shall arrange for records to be kept of all . . . transactions undertaken by it which shall be sufficient to enable the competent authority to fulfill its supervisory tasks and to perform the enforcement actions under this Directive.").

153. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30,968, 31,104 (proposed May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, 249).

154. *Id.*

155. *See* Council Regulation 648/2012, art. 11, 2012 O.J. (L 201) 1, 22 (stating that counterparties must implement procedures and arrangements to monitor risks); *see also* Council Directive 2014/65, art. 16, 2014 O.J. (L 173) 349, 395 (stating that investment firms shall maintain effective approval processes, regularly review products that could affect the potential risk to markets, and make all appropriate product information available); Council Regulation 648/2012, art. 1, 2012 O.J. (L 201) 1, 14 (mandating that counterparties arranging or executing transactions must establish and maintain effective arrangements, and report anything suspicious to the appropriate regulators).

156. *See* Council Directive 2014/65, art. 16, 2014 O.J. (L 173) 349, 396 ("An investment firm shall maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to prevent conflicts of interest."); *see also id.* art. 23, at 404 (defining conflicts of interest).

157. *Id.* art. 9, at 390.

158. *Id.*

159. *See id.* art. 16, at 395. Article 11.3 of EMIR also requires that counterparties "shall have risk-management procedures that require the timely, accurate and appropriately segregated exchange of collateral with respect to OTC derivative contracts." *See* Council Regulation 648/2012, art. 11, 2012 O.J. (L 201) 1, 22.

requirements for counterparties, external business conduct standards,[160] and the segregation of assets.[161]

II. THE UNITED STATES DECIDED OTHER GOVERNMENTS SHOULD GET OFF ITS OTC-DERIVATIVES REGULATORY LAWN

The CFTC and SEC broadly applied their cross-border requirements for similar reasons.[162] They intended to remedy certain realities: (1) major financial firms can escape regulation of their higher-risk operations by moving them to foreign jurisdictions; (2) successful regulation of systemic risk requires regulation of both counterparties to a trade; (3) some nations will profit from assuming the risks of nonregulation, creating "regulatory arbitrage";[163] and (4) only major financial jurisdictions can push international bodies and foreign jurisdictions, by leveraging territorial jurisdiction.[164] As the SEC itself stated, however, the OTC derivatives market is highly international,[165] and substituted compliance could ease the burden of duplicative requirements for counterparties in cross-border transactions.[166] The Commission must, therefore, balance the motivations for its territorial approach against the benefits of substituted compliance in deciding whether to allow it and in what form. The decision of whether to allow substituted compliance for SBS counterparties, and in what form, is the central issue of this Note.

Support for and against substituted compliance lies across a spectrum. There are some SBS industry members who urge the SEC to grant substituted compliance broadly in their comment letters.[167] Some

160. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30,968, 31,010 (proposed May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, 249).

161. *See id.*

162. *See* Coffee, Jr., *supra* note 29, at 1277–85.

163. Regulatory arbitrage is where other countries allow permissive laws for financial firms, becoming "underregulated havens" to attract their business. *Id.* at 1260.

164. *Id.* "Territorial" is the term given the regulatory approach adopted by the SEC and CFTC that uses the United States as a jurisdictional hook for oversight. Regulation SBSR Release No. 34-74244, *supra* note 116, at *151 ("[T]he Commission continues to believe that a territorial approach to the application of Title VII . . . is appropriate.").

165. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30,968; *see also* Coffee, Jr., *supra* note 29, at 1273. Estimates put the exposure of U.S. bank counterparties to foreign counterparties at between 55 and 75 percent of total derivatives exposure. *Id.* In 2011, only around 7 percent of credit-default swaps were between two U.S. counterparties. *Id.* at 1273–74.

166. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. at 30,974.

167. *See, e.g.*, Investment Company Institute & ICI Global, Comment Letter on Proposed Rules on Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers

academics agree that the correct approach for American regulators to OTC derivatives is an internationally coordinated effort like substituted compliance.[168] On the other end of the spectrum, the SEC also received comment letters opposing any sort of substituted compliance determinations by the Commission.[169] In the middle, at least one academic advocates for a diversity of regulatory forms in the OTC derivatives market, a concept both in support of, and opposed to, an SEC substituted compliance scheme.[170] These three main positions are summarized, in turn, in Part II.A, II.B, and II.C.

A. Profits for All: Why the SEC Should Broadly Grant Substituted Compliance

Often, participants of any industry have the operational knowledge to anticipate problems that regulators cannot. To this end, some SBS market participants argue in favor of substituted compliance. Some academics also favor substituted compliance, and their arguments may be more convincing as they are not self-interested market participants.

1. Arguments from Market Participants

Many of the commenters that advocate for substituted compliance are financial industry advocacy groups.[171] These lobbyists promote the interests of a set of diverse financial services clients, including both dealers and purchasers of SBSs.[172] Already familiar with substituted compliance from the CFTC, they favored the possibility of substituted compliance with the SEC.[173] As the cross-border aspects of SEC regulations increase,

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and Major Security-Based Swap Participants 11–13 (Aug. 21, 2013), http://www.sec.gov/comments/s7-02-13/s70213-43.pdf [https://perma.cc/5H4R-RMZK].

168. *See infra* Part II.A.2. Many of these academics' arguments focus on the CFTC's substituted compliance regime, rather than an SEC scheme. Their arguments are mainly over the substance and philosophy of the concept of substituted compliance, however, and not the form of the SEC or CFTC schemes. These arguments are applicable to the SEC's framework because the Commission has many of the same reasons for substituted compliance as the CFTC.

169. *See infra* Part II.B.

170. *See infra* Part II.C.

171. *See, e.g.*, ISDA, Comment Letter on Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants (Aug. 14, 2013), http://www.sec.gov/comments/s7-02-13/s70213-31.pdf [https://perma.cc/5XTE-9L3B].

172. *See About ISDA*, ISDA, http://www2.isda.org/about-isda/ (last visited Oct. 16, 2016) [https://perma.cc/45TW-J3PN]. Most major SBS dealers, or a subsidiary entity, are members of ISDA. *See ISDA Members*, ISDA, http://www2.isda.org/membership/members-list/ (last visited Oct. 16, 2016) [https://perma.cc/ZAC7-J824]. ISDA also includes other professional associations, like law firms, accounting firms, supranational regulators, and government agencies. *See id.*

173. *See* ISDA, *supra* note 171, at 2 (addressing "the need for harmonization with the Commodity Futures Trading Commission" and the SEC regarding its proposal of substituted compliance).

commenters continue to request substituted compliance during rulemaking periods.[174]

Their advocacy of substituted compliance is motivated by economic concerns of overregulation with the SEC's territorial approach to cross-border transactions.[175] These groups argue that Dodd-Frank's SBSs requirements and those of foreign regulators are substantially similar and, in practice, duplicative.[176] When counterparties are required to comply with the same requirements in multiple jurisdictions, no additional protections result, and the extra work inhibits the flow of transactions.[177] The SEC could solve these business problems by establishing a comprehensive substituted compliance framework.[178] Additionally, substituted compliance would "foster reciprocity and mutual recognition" between the SEC and foreign regulators.[179] Finally, if American counterparties retreat from the global market because of their unwillingness to comply with duplicative requirements, it could fragment the markets for SBSs into an American tier and a foreign tier.[180] This would decrease the overall liquidity of the global market.[181] Either result could expose the American economy to systemic

174. ICI Global, Comment Letter on Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent (July 13, 2015), http://www.sec.gov/comments/s7-06-15/s70615-15.pdf (arguing that the SEC should repropose margin rules for counterparties to allow for substituted compliance) [https://perma.cc/PGW3-XTBK]; ISDA, Comment Letter on the Proposed Rules, Rule Amendments and Guidance on Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information 19–20 (May 4, 2015), http://www.sec.gov/comments/s7-03-15/s70315-7.pdf (arguing that territorial requirements should not be imposed until relevant substituted compliance determinations have been made) [https://perma.cc/JNH7-M22K]; *see also* Institute of International Bankers, Comment Letter on Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent (July 13, 2015), http://www.sec.gov/comments/s7-06-15/s70615-16.pdf [https://perma.cc/G2FG-NFTU]; Managed Funds Association, Comment Letter on Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected with a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent 9 (July 13, 2015), http://www.sec.gov/comments/s7-06-15/s70615-26.pdf (advocating for the SEC's approach to substituted compliance) [https://perma.cc/68N4-F3HY].

175. *See, e.g.*, ISDA, *supra* note 174, at 2 (citing the enormous implementation and compliance challenges and cost for firms).

176. *Id.*

177. *See* ISDA, Comment Letter on the Application of Certain Title VII Requirements to Security-Based Swap Transactions Connected With a Non-U.S. Person's Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent 5 (July 13, 2015), https://www.sec.gov/comments/s7-06-15/s70615-20.pdf ("Non-U.S. market participants may not wish to subject themselves to the increased burden and complexity of U.S. regulation when dealing with non-U.S. counterparties, particularly as they may be subject to comparable regulation in their home jurisdictions.") [https://perma.cc/Y3QD-TVHJ].

178. *See generally* ISDA, *supra* note 174.

179. *See* ISDA, *supra* note 177, at 10.

180. *Id.* at 5.

181. *Id.*

risks because American financial companies will continue to rely on the credit of foreign companies in other markets.[182]

2. Academics Who Advocate for Substituted Compliance . . . or Something Like It

Some in the academic community also argue against the SEC's territorial approach to OTC derivatives regulations.[183] Instead, they propose broader and internationally integrated approaches such as harmonization, mutual recognition, and minilateralism.[184] Although the academics who argue for these approaches may not advocate for substituted compliance specifically,[185] these approaches have justifications analogous to those for substituted compliance.[186]

a. Harmonization

In cross-border regulatory systems, harmonization seeks to "achieve substantial similarity in multiple regulatory systems so that market participants face no additional burden in pursuing cross-border activities."[187] To begin, harmonization includes a step fundamental to any substituted compliance determination[188]: the bilateral assessment to determine the compatibility of the regulations of two jurisdictions.[189] This assessment may require discussions to help ensure that no regulatory gaps or systemic risks exist.[190]

After the initial assessment, efforts by the regulators of the two jurisdictions to close gaps between frameworks and make them more similar, or even equivalent, is "harmonization."[191] Harmonization,

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182. *See* Coffee, Jr., *supra* note 29, at 1260 ("This is because major financial institutions are not only 'too big to fail' but also 'too interconnected to fail.'").

183. *See, e.g.*, *id.* at 1296–97.

184. *See infra* Part II.A.2.a–c.

185. Professor John C. Coffee Jr. argues against substituted compliance as presently contemplated but not necessarily against the concept. *See* Coffee, Jr., *supra* note 29, at 1298–99. In contrast, Edward F. Greene has argued directly for implementation of a substituted compliance framework. *See* Edward F. Greene, *Beyond Borders: Time to Tear Down the Barriers to Global Investing*, 48 HARV. INT'L L.J. 85 (2007).

186. *See infra* Part II.A.2.

187. Greene & Potiha, *supra* note 60, at 308. Greene and Potiha wrote specifically about the CFTC's cross-border approach to margin requirements, but this Note generally applies their arguments to the SEC's entire cross-border approach. Also, Greene and Potiha both contribute scholarship and work in private practice and are, therefore, not full-time academics. *See id.* at 271.

188. *See* Greene, *supra* note 185, at 90–91.

189. *Id.* This assessment could be done by either a "forest" (generalized) approach or a strict rule-by-rule comparison. *Id.*

190. *Id.*

191. *Id.* Greene believes that a strict rule-by-rule comparison of a jurisdiction's regulations, followed by harmonization of those regulations, would be "indistinguishable from a requirement of regulatory convergence," or two jurisdictions creating requirements in tandem. *Id.* at 91. He disavows this approach both because Americans should "take pride" in their system and because harmonization frustrates a main purpose of any substituted

therefore, can go further than substituted compliance, since two jurisdictions can converge regulations.[192] For example, if regulators at the SEC and in the European Union conformed the margin requirements for SBSs, then counterparties would calculate and maintain the same levels of funds to comply with both jurisdictions.[193] Harmonization also could be achieved through the implementation of transactional standards by supranational regulators.[194] In the context of OTC derivatives, this may require an international body to set minimum requirements for counterparties.[195] Minimum requirements through harmonization would decrease risks of competition, duplication, and fragmentation.[196] In either form of harmonization, however, the objectives of substituted compliance are also accomplished, as SBS counterparties would be subject to only one regulatory scheme.[197]

b. Mutual Recognition

Conceptually, "mutual recognition"[198] is substantially similar to substituted compliance. Edward F. Greene and Ilona Potiha ultimately believe mutual recognition, rather than harmonization, is the correct approach to cross-border regulatory issues in the United States.[199] Recognition can be unilateral or mutual between jurisdictions.[200] Mutual recognition by one government, "unilateral recognition," would result in one jurisdiction determining another's regulations are equivalent to its own and, therefore, that no further regulation is required on its part.[201]

Greene and Potiha also enumerate risks associated with the territorial approach to cross-border transactions.[202] Mutual recognition would alleviate some of these risks by removing duplicative regulations from cross-border transactions, discouraging regulatory arbitrage, and promoting

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compliance regime. *Id.* Namely, he believes it frustrates the "race to optimality" goal that comes from regulatory experimentation. *Id.*

192. *See id.*

193. *See supra* Part I.B.2.a, I.C.1.

194. *See* Greene & Potiha, *supra* note 60, at 308.

195. *Id.*

196. *Id.* Greene and Potiha argue that harmonization is unlikely to ever reach its theoretical goals, however, because regulators will not set their own requirements quickly enough to prevent counterparties from becoming uncompetitive and losing clients. *See id.* at 309 n.166.

197. *See id.* at 308 (describing harmonization as a framework "under which the rules can operate across borders without unduly restricting cross-border activity and flow of funds").

198. Mutual recognition involves a determination by one jurisdiction that another jurisdiction's regulatory regime is sufficient to regulate counterparties from that jurisdiction without additional regulation by the host country regulator. *Id.* at 310.

199. *Id.* at 310–11. As discussed, Greene and Potiha use the SEC's prior substituted compliance determination as an example of mutual recognition. *See supra* note 70 and accompanying text.

200. *See* Greene & Potiha, *supra* note 60, at 310.

201. *Id.*

202. *Id.* at 299–304. These include competitive disadvantages, driving business away, duplicative requirements, and market fragmentation. *Id.* If the market for SBSs were to leave the United States, it could deprive the SEC of oversight over the market.

a more coordinated approach to regulation.[203] It also encourages some differences between laws, as jurisdictions need only find each other's laws "equivalent."[204] Thus, the SEC's and European Union's margin requirements could be equivalent, even though counterparties in the European Union hold funds for capital requirements in their own accounts as opposed to the accounts of a third-party custodian under the SEC's requirements.[205]

Implementing a mutual recognition scheme, however, would be difficult given the technical nature of comparing regimes.[206] It also is uncertain whether mutual recognition is possible, given that the rationale behind the SEC's territorial approach is the systematic prevention of contagion and interconnected risk.[207] This rationale creates a "tension" because mutual recognition relies on deferring to foreign laws and governments.[208] Mutual recognition of foreign regulations by American agencies would, ultimately, promote the efficiency of cross-border markets by removing duplicative requirements.[209]

c. Not Maxi-, but Minilateralism

Professor John C. Coffee Jr. proposes an alternative approach to substituted compliance.[210] He believes the costs of substituted compliance may outweigh the benefits.[211] Instead, Coffee argues that successful international collaboration among governments can be achieved through a "minilateral" approach to financial regulation.[212] Coffee compares the territorial approach of American regulators to imperialism, which will be resisted in other parts of the world.[213] However, the accepted approach of

203. *Id.* at 310. Mutual recognition would, presumably, decrease regulatory arbitrage if it was implemented on a large scale but may increase it if implemented only on a smaller scale. It would also, however, include an enforcement mechanism not necessarily included in the harmonization context. *Id.*

204. *Id.* These small differences would allow the benefits of the "race to optimality" of regulation described by Edward F. Greene. *See supra* note 191 and accompanying text.

205. *See supra* Part I.B.2.a, I.C.1.

206. *See* Greene & Potiha, *supra* note 60, at 310. Regulators would need to understand another jurisdiction's SBS laws, which would require time and resources, although this problem would exist in any substituted compliance determination as well.

207. *See id.* at 311.

208. *Id.*

209. *Id.* at 310.

210. *See* Coffee, Jr., *supra* note 29, at 1265.

211. *See id.* In his view, the risks with substituted compliance arise not only because financial services companies would seek to escape regulation but also because different jurisdictions move at different lawmaking speeds. *Id.* at 1274, 1299. A slower decision-making process is to be expected in Europe, for example, because it is naturally a more fragmented polity. *Id.*

212. *Id.* at 1265. Minilateralism is contrasted with the more common concept "multilateralism," where countries discuss issues and ultimately forge agreements such as treaties. *Id.* at 1265–66.

213. *Id.* at 1263–65.

"soft law"[214] does not have the force or speed to solve issues like the causes of the financial crisis.[215]

A minilateral approach would first ask, "[W]hat is the smallest number of nations needed to reach a workable solution to a specific problem?"[216] Regarding systemic risk caused by OTC derivatives, only the major financial jurisdictions like the United States and Europe have the incentives to address the issues that originated in unregulated OTC derivatives markets.[217] Therefore, the United States and European Union should act minilaterally to define functional equivalence to support substituted compliance.[218] This could prevent attempts by the SEC to run "roughshod" over foreign laws or an attempt by the financial services industry to evade Dodd-Frank requirements.[219] An agreement between the European Union and United States also would provide a template for other jurisdictions to follow.[220] Finally, if the European Union and United States deny access to their financial institutions, these other jurisdictions could be motivated to adopt the template by loss of market share.[221]

B. Clear and Present Dangers: Why the SEC Should Not Grant Substituted Compliance

The commenters who oppose substituted compliance argue that it could undermine Dodd-Frank by effectively outsourcing oversight to foreign regulators and that it overlooks the potential for systemic risk and financial

214. Soft laws with respect to issues of financial regulation are "broad, noncompulsory, and sometimes aspirational, principles that are announced by international bodies, such as the International Monetary Fund or the World Bank." *Id.* at 1265.

215. *Id.*

216. *Id.*

217. *Id.* at 1267 ("[T]he United States and the EU have the best incentives for controlling systemic risk because they will likely bear the lion's share of the costs from a financial contagion."). Other countries with less developed financial infrastructures largely escaped damage from OTC derivatives, and other forms of financial engineering, during the financial crisis. *Id.* at 1266.

218. *Id.* at 1267, 1298–99.

219. *Id.* at 1267.

220. *Id.* at 1298 ("In the world of OTC derivatives, an agreement between the United States and Europe would effectively compel the rest of the world to conform to their agreed standards.").

221. *Id.* at 1270.

contagion.[222] These commenters are usually financial industry accountability groups[223] that desire enforcement of financial laws.[224]

First, they argue that foreign OTC derivatives laws may not be sufficiently equivalent to American laws to support substituted compliance.[225] "Even regimes of comparable robustness" will contain asymmetries that could generate loopholes, and financial companies are "notorious" for finding and exploiting these loopholes.[226] For example, financial companies may create subsidiaries in different jurisdictions to take advantage of different laws.[227]

Second, even if foreign laws are sufficiently similar to American laws, the Commission has not done enough to ensure that foreign laws are enforced similarly.[228] The SEC makes only "passing reference" to foreign enforcement when it should consider other factors.[229] Enforcement of existing laws, therefore, concerns these commenters because the laws are meaningless without their enforcement.[230]

Third, they argue that Congress chose not to establish substituted compliance in Dodd-Frank.[231] They also criticize the SEC's process for substituted compliance, arguing it is not public or transparent enough, and that only after its scheme is subject to more rigorous standards can the Commission have "adequate legal or policy justification" for substituted

222. *See, e.g.*, Americans for Financial Reform, Comment Letter on Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants (Aug. 22, 2013), http://www.sec.gov/comments/s7-02-13/s70213-54.pdf ("[T]he SEC should not place the interests of financial institutions . . . over the statutory mandate of Dodd-Frank.") [https://perma.cc/7PDG-EPHG]; Better Markets, Comment Letter on Cross-Border Security Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rule and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants (Aug. 21, 2013), http://www.sec.gov/comments/s7-02-13/s70213-42.pdf [https://perma.cc/AJL6-GXC6].

223. *See About AFR*, AMERICANS FIN. REFORM, http://ourfinancialsecurity.org/about/ (last visited Oct. 16, 2016) [https://perma.cc/2DN3-JJNR]; *About Us*, BETTER MARKETS, https://www.bettermarkets.com/about-us (last visited October 16, 2016) [https://perma.cc/2KWL-5MVF].

224. *See About AFR*, *supra* note 223 (describing the group as "a nonpartisan and nonprofit coalition of more than 200 civil rights, consumer, labor, business, investor, faith-based, and civic and community groups" formed in the wake of the financial crisis to work for a strong and ethical financial system).

225. *See* Better Markets, *supra* note 222, at 24–29. They also have "serious concerns regarding the procedure for such comparability determinations" laid out in the SEC Cross-Border proposal. Americans for Financial Reform, *supra* note 222.

226. Better Markets, *supra* note 222, at 25.

227. *See id.* (discussing the 2,993 subsidiaries JPMorgan Chase uses to exploit regulatory differences between jurisdictions around the world).

228. *Id.* at 30–31.

229. *Id.* at 30. These include "staff expertise, agency funding, agency independence, technological capacity, supervision in fact, and enforcement in fact." *Id.* at 31. They also argue that enforcement is consistent and ongoing. *Id.*

230. *Id.* at 32. Also, they discuss the issue of changes to foreign laws after the SEC has allowed substituted compliance. *Id.*

231. *See id.* at 25.

compliance.[232] In addition, they criticize the outcomes-based approach.[233] The SEC should use the more "narrow" rule-by-rule comparison approach, which will ensure long-term comparability, rather than the "overly vague" outcomes test.[234]

C. One Size of OTC Derivatives Regulation Does Not Fit All

A substituted compliance determination deems the laws of another jurisdiction essentially equivalent to, or uniform with, those of the SEC.[235] Professor Sean Griffith argues against uniform global regulation for OTC derivatives.[236] Providing for a diversity of regulatory approaches offers benefits otherwise unavailable in a uniform system.[237] To address systemic risk, governments must understand that regulators not only make mistakes but also often repeat them.[238]

A diversity of approaches would allow for compartmentalization of risks as regulators in different jurisdictions impose different requirements.[239] This would create the inverse of regulatory arbitrage: regulators would innovate requirements that stem risk and provide information about successful approaches rather than opening their borders to companies seeking the least regulation, fueling a race toward the regulatory bottom.[240] This could, for example, prevent contagions of the sort that spread to American markets through a British subsidiary of AIG.[241] Regulators around the world, working independently, would pull global regulation upward by creating structural barriers to contagion and risk.[242]

In comparison, Griffith believes substituted compliance leads to two questions: "[W]hat is sufficiently similar? And . . . who decides?"[243] Whichever regulatory bodies make the determinations, they should consider whether the foreign laws increase systemic risk or undermine the U.S. financial system in some other way.[244] Ultimately, the decision should not

232. *See id.* at 24; *see also* Americans for Financial Reform, *supra* note 222.
233. *See* Better Markets, *supra* note 222, at 30–31.
234. *See id.* at 30.
235. *See supra* note 19 and accompanying text.
236. *See* Griffith, *supra* note 6, at 1293.
237. *Id.* at 1294. These include the promotion of innovation, the adoption of efficient regulatory structures, and the production of information about different approaches to issues. *Id.*
238. *Id.* at 1347–49.
239. *Id.* at 1372.
240. *Id.* at 1372–73. Regulatory arbitrage is the malevolent outcome of independent systems of regulatory rules over the same financial market. *See supra* note 163 and accompanying text.
241. *See supra* note 40 and accompanying text.
242. Griffith, *supra* note 6, at 1372–73.
243. *Id.* at 1369. In Griffith's opinion, neither the CFTC nor the SEC should be making substituted compliance determinations. *Id.* at 1370. He argues that the review committee must be independent of the agency responsible for "drafting and implementing the domestic regulation." *Id.*
244. *Id.* at 1369. Griffith also believes that whether the CFTC or SEC makes substituted compliance determinations, neither entity's authority or discretion should extend internationally. *Id.* at 1372.

be whether the laws of another jurisdiction are functionally equivalent but whether they provide a "robust approach to the underlying problem of systemic risk."[245]

III. A NARROW AND NECESSARY COMPROMISE

To address the issue surveyed in Part II, this Note proposes that the SEC follow the general path of the CFTC[246] and institute substituted compliance. Because many large financial companies transact in both swaps and SBSs,[247] they currently operate under two different approaches to cross-border transactions for economically equivalent products.[248] Economic efficiency would be increased if these inconsistent approaches were remedied through substituted compliance.

The SEC's substituted compliance policy, however, should be narrower in form than that of the CFTC. It should grant substituted compliance for European dealers, and American dealers with European subsidiaries, transacting in cross-border OTC SBSs. This approach would not only fulfill the purposes of Dodd-Frank but also protect against global systemic risk while maintaining the competitiveness of American financial companies.[249]

This resolution is presented in two parts. Part III.A, argues that substituted compliance should be allowed solely for dealers, while Part III.B argues that the European Union is the only jurisdiction for which the SEC should allow substituted compliance.

A. Why Not Substituted Compliance for All Market Participants?

Although substituted compliance can create benefits and prevent issues in the SBS markets and the American economy, the risk of another financial crisis should prevent the SEC's extension of substituted compliance beyond dealers. To develop this argument, Part III.A.1 discusses the benefits of allowing substituted compliance for dealers. Part III.A.2 then presents the potential risks of the SEC not allowing it for dealers, before ending with why the SEC should not allow substituted compliance for other market participants.

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245. *Id.*

246. If the Commission undertakes substituted compliance, it will be different in form from the CFTC's scheme. *See supra* note 118 and accompanying text.

247. *See* Thompson, *supra* note 53.

248. *See* ISDA, *supra* note 171, at 4 (citing the uncertainties, confusion, and inefficiencies of the differences between the CFTC and SEC).

249. This Note adopts a similar position to that of Professor Coffee, *see supra* Part II.A.2.c, but one that differs significantly in form and reasoning, *see infra* Part III.B.

1. The Economy, Stupid

Large financial institutions, such as dealers in the SBS market, are typically identified as "the cause" of the financial crisis.[250] They carry massive influence over the market by selling vast quantities of OTC SBSs.[251] Indeed, they amplified the damage of the financial crisis by exposing markets around the world to SBSs.[252] As discussed, substituted compliance for SBS dealers would allow them to avoid costly regulatory requirements and would, therefore, benefit them.[253] It would be a conspicuous advantage to a group responsible for fundamental causes of the financial crisis.[254]

The SEC, however, should ultimately harmonize[255] with the CFTC, and institute substituted compliance.[256] First, if the SEC granted substituted compliance for another jurisdiction, it affirms that jurisdiction has requirements equivalent to those of Dodd-Frank.[257] The protections Dodd-Frank mandates to prevent another financial crisis would, therefore, exist.[258] Second, current duplicative requirements put American dealers at a competitive disadvantage in the market.[259] The SEC exempted all but the largest dealers of SBSs from its requirements anyway, through the minimum thresholds for registration.[260] These dealers have the resources to avoid SEC regulations by taking advantage of regulatory arbitrage.[261] Alternatively, if the SEC prevents regulatory arbitrage, American dealers

250. *See Crash Course*, *supra* note 4. Additionally, it is accepted that CDSs and CDOs were the financial instruments to blame. *See id.*; *see also* Griffith, *supra* note 6 at 1304–05.

251. An estimated 80 percent of SBSs, by notional volume, have ISDA-recognized dealers as counterparties on both sides of transactions. *See* Press Release, SEC, SEC Adopts Cross-Border Security-Based Swap Rules (June 25, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542163722 [https://perma.cc/6ASD-9QAD].

252. *See* Coffee, Jr., *supra* note 29, at 1262.

253. *See supra* Part I.B.3. This especially includes capital and margin requirements. *See supra* notes 82–83 and accompanying text.

254. *See* Coffee, Jr., *supra* note 29, at 1262. Additionally, there is political stigma that can occur with the appearance of support for large financial institutions. *See* Senator Sherrod Brown et al., Comment Letter on Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants 1–2 (May 22, 2013), http://www.sec.gov/comments/s7-02-13/s70213-2.pdf [https://perma.cc/5KV6-5JBD].

255. Greene and Potiha described the form this would take. *See supra* Part.II.A.2.a.

256. *See* CFTC, *Comparability Determinations*, *supra* note 67.

257. *See supra* notes 117–21 and accompanying text.

258. *See* Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30,968, 30,972 (proposed May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, 249) ("The Dodd-Frank Act was enacted . . . to promote the financial stability of the United States by improving accountability and transparency in the financial system.").

259. *See* Greene & Potiha, *supra* note 60, at 302 (explaining that "duplicative margin collection requirements would make it costly and burdensome to demonstrate compliance" with multiple regimes).

260. *See supra* note 76.

261. *See supra* note 164 and accompanying text; *see also supra* note 226 and accompanying text.

may decide SBSs are too costly because of the Commission's regulations.[262] Dealers would leave the market to create and sell less regulated, more profitable products.[263] In either scenario, the liquidity of the SBS market would diminish, and "fragmentation" would occur.[264]

As a result, counterparties would be less able to mitigate risks through hedging.[265] Their trading profits through speculation also would be limited.[266] This would be in addition to the losses of SBS profits as counterparties left the market due to regulatory costs. Finally, the SEC would have less regulatory oversight in a fragmented market or a market in which a substantial number of American SBS dealers exit. Whether through the SBS market or not, large financial companies are inextricably connected to other financial companies throughout the world.[267] As long as the SBS market persists without sufficient oversight, American companies and, therefore, the American economy, will be exposed to its risks through the exposure of American financial companies to foreign financial companies in the numerous other financial markets.[268]

2. What Could Be Lost Without Substituted Compliance

Some argue the economic benefit provided by American SBS dealers is dwarfed by the importance of what is mandated by Dodd-Frank.[269] Despite the damage of the financial crisis, hedging is fundamental to risk management for financial companies, and cross-border SBSs are necessary to provide market liquidity for hedging.[270] That is why the G20 leaders elected to regulate SBSs rather than ban them.[271] Though some downplay the economic benefits of SBSs, these benefits could be significantly reduced by the regulatory burdens of Dodd-Frank.[272]

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262. *See* Coffee, Jr., *supra* note 29, at 1276–77.

263. As Professor Coffee explains, the sophistication of large financial institutions gives them options to avoid regulation. *See id.* at 1262.

264. Fragmentation of markets occurs when entities augment their businesses because of local regulation, and generally results in decreased safety and liquidity of markets. *See* Greene & Potiha, *supra* note 60, at 303. The illiquidity of markets, as discussed, is an issue commenters have previously brought up with the Commission as undermining the objectives of Dodd-Frank. *See* ISDA, *supra* note 179.

265. This could also substantially tighten the credit markets, as credit underwriters have fewer options to hedge their risk positions. *See* Ellen Brown, *Credit Default Swaps: Evolving Financial Meltdown and Derivative Disaster Du Jour*, GLOBAL RES. (Dec. 5, 2012), http://www.globalresearch.ca/credit-default-swaps-evolving-financial-meltdown-and-derivative-disaster-du-jour/8634 [https://perma.cc/B442-WRP7].

266. Speculation through use of SBSs was a magnifying factor of the financial crisis. *See supra* note 33 and accompanying text.

267. *See* Coffee, Jr., *supra* note 29, at 1272–74.

268. *See id.* This includes the risks that led to the financial crisis. *See id.*

269. *See supra* note 222 and accompanying text.

270. *See supra* note 6; *see also* Greene & Potiha, *supra* note 60, at 290–91.

271. *See* Leaders' Statement, G-20, *supra* note 10.

272. *See* Coffee, Jr., *supra* note 29, at 1283.

Furthermore, the loss of American SBS dealers is a risk that could harm the economy further.[273] If the SEC both diminished the liquidity of the SBS market, and effectively ceded jurisdiction over the market, it could undermine Dodd-Frank.[274] These issues would be avoided through substituted compliance, as would the image of American regulatory imperialism.[275] Substituted compliance would strike a regulatory balance between economic benefits and risk protections.[276]

Given the advantages substituted compliance creates for the American economy, the SEC could grant it broadly to purchasers of SBSs.[277] The Commission denied this possibility in its initial guidance on substituted compliance,[278] and it should not extend substituted compliance to all market participants at this time. First, if smaller purchasers exit the market because of regulatory costs, it will not harm market liquidity or shrink the American economy as much as an exit of large dealers.[279] Second, though large financial companies can be publicly unpopular, they have more incentive to comply with SEC regulations, or equivalent foreign laws, than SBS participants. Large financial firms have visible brands and reputations based on public perception of compliance with laws and regulations that smaller and less well-known counterparties do not have.[280] Finally, the absence of regulation was a cause of the financial crisis, and granting substituted compliance to all participants could cede oversight for relatively minimal economic benefits.[281]

B. If the European Union, Why Not the World?

The SEC, in striking the correct regulatory balance, could capture most of the SBS market through a substituted compliance determination with the European Union.[282] This is possible because almost all of the large dealers

273. *See id.*; *see also* ISDA, *supra* note 179, at 5 (stating that dealers may move employees out of the United States to avoid "burdensome and duplicative regulation").

274. *See supra* notes 263–64 and accompanying text.

275. *See* Coffee, Jr., *supra* note 29, at 1264 (discussing a prior foreign concern about a "tradition of U.S. imperialism under which the United States assumed that its preferred financial practices could be mandated for the rest of the world"); *see also id.* at 1266 ("[T]he United States cannot effectively exercise that authority in the face of unified international opposition.").

276. *See supra* notes 250, 254 and accompanying text.

277. Some commenters also argue for this. *See, e.g.*, Managed Funds Association, Comment Letter on Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants 2 (Aug. 19, 2013), https://www.sec.gov/comments/s7-02-13/s70213-34.pdf (stating that substituted compliance must "encompass[] all transaction-level requirements that apply to U.S. and non-U.S. persons conducting transactions within the United States") [https://perma.cc/VV4E-N4EQ].

278. *See supra* note 112.

279. This is because the market is heavily based around dealers, who both sell and purchase SBSs. *See supra* note 251 and accompanying text.

280. *See, e.g.*, *Crash Course*, *supra* note 4.

281. *See supra* Part II.B.

282. Although Switzerland is not part of the European Union, the Commission should consider it effectively part of the European Union because of its substantial legal and economic ties, *see Switzerland*, EUR. COMMISSION, http://ec.europa.eu/trade/policy/countries-

are based in either of the two jurisdictions,[283] and most SBSs are between two dealers.[284] Moreover, the current E.U. SBS laws are equivalent to American requirements for dealers using the approach stated by the SEC.[285] Through this limited action, the Commission could provide many of the benefits advocated for in Part II, while avoiding many of the risks of its territorial approach.[286]

Part III.B.1 argues for the equivalence of E.U. laws to SEC regulations. Following this, Part III.B.2 analyzes why there are no enforcement issues with the European Union. Finally, Part III.B.3 explains why the SEC need not make any other substituted compliance determinations.

1. Existing Equivalence

As discussed, the SEC's outcomes-based approach[287] has been criticized as vague[288] and has never been applied in any public statement by the Commission.[289] After applying the approach as described by the Commission, however, the European Union's information reporting and recordkeeping requirements for SBS dealers are functionally equivalent to the SEC's current regulations under Dodd-Frank.[290] This would leave only capital and margin requirements for a substituted compliance determination.[291] As discussed, the European capital requirements are the only requirements enacted between both governments for either capital or

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and-regions/countries/switzerland/ (last visited Oct. 16, 2016) [https://perma.cc/NTB7-PPHZ], and grant it substituted compliance as well under the greater umbrella of the European Union. Switzerland is home to two large dealers: Credit Suisse and UBS. The same is now true of the United Kingdom, which recently departed from the European Union. *See* Fraser Nelson, *Brexit: A Very British Revolution*, WALL ST. J. (June 24, 2016, 4:33 PM), http://www.wsj.com/articles/brexit-a-very-british-revolution-1466800383 [https://perma.cc/3SWU-NAW6]. As of fall 2016, it is too early to know what the United Kingdom's financial regulations and laws will look like after leaving the European Union. However, because the United Kingdom is also home to three large dealers, Barclays Capital, HSBC, and RBS, it would be appropriate for the SEC to grant the United Kingdom substituted compliance, assuming it maintains its current laws and political status as essentially equivalent to the European Union.

283. This group of dealers includes the following American-based financial institutions: Goldman Sachs, Morgan Stanley, JPMorgan Chase, Bank of America Merrill Lynch, Citigroup, and Wells Fargo. It also includes the following European-based (including Switzerland and the United Kingdom) financial institutions: Credit Suisse, Deutsche Bank, Barclays Capital, HSBC, BNP Paribas, the Royal Bank of Scotland, Societe Generale, and UBS. Of the world's largest dealers, this would leave only the Japanese Nomura and the Canadian RBC outside of the ambit of the SEC's regulations.

284. *See* Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. 47,278, 47,284 n.52 (Aug. 12, 2014) (to be codified at 17 C.F.R. pts. 240, 241, 250) (stating that the Commission estimates 80 percent of the SBS market is between thirteen large entities).

285. *See infra* Part III.B.1.

286. *See supra* Part II.A.

287. *See supra* note 121 and accompanying text.

288. *See supra* note 234 and accompanying text.

289. *See supra* notes 109, 123 and accompanying text.

290. *See supra* Part I.C.

291. *See supra* Part I.B.2–3.

margin.[292] It would be in the best interests of the European Union, the SEC, and counterparties for the two governments to coordinate regulation in efforts that resembled mutual recognition and make them functionally equivalent.[293] These efforts also would affirm the SEC's commitment to coordination with foreign regulators.[294] Based on SEC guidance and the current state of European and American capital and margin requirements, however, they are functionally equivalent.

2. These Equivalent Laws Will Be Enforced

Even if European SBS laws were equivalent to American laws, however, there would need to be equivalent enforcement of them.[295] The preliminary hurdle in equivalent enforcement is the discretion member states have to implement directives.[296] If member states implement softer versions, the enforcement of directives would differ, and the possibility of regulatory arbitrage between member states would increase.[297] There are mechanisms in the European Union, however, to prevent this from occurring. First, the level of discretion afforded member states differs on a directive-by-directive basis.[298] The pertinent directives at issue in this Note afford little discretion to E.U. member states in implementation.[299] Additionally, none of them have provisions that allow member states to opt out of directives,[300] and these regulations and directives have enforcement provisions.[301] The European Union also has pan-European legislation to ensure proper financial regulation,[302] and it already had OTC derivatives regulations in MiFID 1 prior to the financial crisis, when the United States had none.[303]

There are also political and economic pressures between the United States and European Union that help ensure equivalent enforcement. The

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292. *See supra* Part I.B–C.

293. *See supra* Part II.A.2.b. Through this endeavor, the Commission would also be applying a purer form of the minilateral approach for which Professor Coffee advocates. *See supra* Part II.A.2.c.

294. *See, e.g.*, Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 Fed. Reg. 30,968, 30,974 (proposed May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, 249).

295. *See supra* note 230 and accompanying text.

296. *See supra* note 126 and accompanying text.

297. Regulatory arbitrage is a focus of those opposed to substituted compliance. *See* Americans for Financial Reform, *supra* note 222.

298. *See* Josephine Hartmann, *Discretion in EU Law—A Total Mismatch?*, UNIVERSITEIT LEIDEN L. BLOG (Feb. 5, 2013), http://leidenlawblog.nl/articles/discretion-in-eu-law-a-total-mismatch [https://perma.cc/W5TD-2BM9].

299. *See, e.g.*, Council Directive 2004/39, arts. 5, 9–10, 12–13, 2004 O.J. (L 145) 1, 12–14.

300. *See generally* Council Directive 2014/65, 2014 O.J. (L 173) 349; Council Directive 2013/36, 2013 O.J. (L 176) 338; Council Directive 2004/39, 2004 O.J. (L 145) 1.

301. *See* Council Directive 2004/39, art. 51, 2004 O.J. (L 145) 1, 33 (describing the use of criminal sanctions for breaches of the directive); *see also* Council Regulation 648/2012, art. 12, 2012 O.J. (L 201) 1, 24.

302. *See European Economic Area*, EFTA, http://www.efta.int/eea (last visited Oct. 16, 2016) [https://perma.cc/4GKW-GC84].

303. *See* Council Directive 2004/39, 2004 O.J. (L 145) 1.

European Union is one of the only other jurisdictions that suffered economic consequences from the financial crisis as harsh as the United States.[304] It also has similar levels of financial and economic development as the United States[305] and is a close political and economic ally of the United States. Finally, American and European regulators already consult on SBS regulations.[306]

3. European and American Market Influence

Substituted compliance between the SEC and European Union would capture the majority of global SBSs within the ambit of Dodd-Frank. The two jurisdictions regulate the majority of the world's large dealers.[307] These dealers are the largest financial institutions in the world and have vast resources in an industry with high regulatory barriers to entry.[308] It is, therefore, unlikely that dealers would develop rapidly in jurisdictions outside of regime's scope.[309] Again, substituted compliance between the SEC and the European Union would accomplish sound regulation with limited Commission action.[310] Given the two jurisdictions' political and economic ties, the ongoing regulatory dialogue also would likely ensure flexibility to address any necessary changes in the future.[311]

Additionally, many of the incentives for substituted compliance with the European Union do not exist for other jurisdictions, and, therefore, the Commission should not make any other determinations. First, it is not clear that any other jurisdictions have SBS laws equivalent to the American laws, like the European Union does.[312] Second, no other jurisdiction has the density of large SBS dealers.[313] Third, the SEC risks undermining Dodd-Frank,[314] criticism from the public or Congress, and litigation with any determination.[315] Fourth, the close political and economic ties of the United States and European Union do not exist with every jurisdiction in the world.[316] Therefore, it is harder to rely on the enforcement of equivalent laws, or trust other governments to act in a coordinated manner.

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304. *See* Coffee, Jr., *supra* note 29, at 1266.

305. *See id.*

306. *See* Joint Statement, *supra* note 136. European and American regulators stressed the importance of implementing the G20 commitments for OTC derivatives, minimizing divergences to the extent possible and the need to consult with each other. *Id.*

307. *See supra* note 283.

308. *See supra* notes 225–26 and accompanying text.

309. *See supra* note 283 and accompanying text.

310. *See supra* Part III.B.

311. *See supra* note 306.

312. *See supra* Part III.B.1.

313. *See supra* note 283 and accompanying text.

314. *See supra* Part II.B; *see also* Coffee, Jr., *supra* note 29, at 1267 ("At worst, it could enable the financial services industry to achieve an effective end run around the Dodd-Frank Act's requirements.").

315. *See* Brown et al., *supra* note 254.

316. Though the United States obviously has close economic ties with jurisdictions like Australia, Canada, and Japan.

Other governments also may tailor their SBS laws to Dodd-Frank without any further Commission action. If the SEC and E.U. regulators acknowledge a shared framework, it would establish it as the leading standard internationally.[317] Jurisdictions may adopt a similar framework as an attempt to not only properly regulate markets but also create the potential for substituted compliance with the SEC.[318] Regardless of whether other jurisdictions match their laws to Dodd-Frank, foreign dealers will continue to transact in the United States and Europe out of necessity.[319] The United States and European Union have the largest capital markets in the world,[320] and transactions will continue because of precedent. Other jurisdictions could choose to benefit from regulatory arbitrage,[321] but it is unlikely given the discussed motivations and the nature of the SBS market. Finally, if regulators around the world are left to create individual systems, it could provide the compartmentalization of risks brought by regulatory diversity.[322]

CONCLUSION

The ruin inflicted by the financial crisis cannot be overstated. Average people who had not participated in the opaque SBS market bore much of the financial brunt.[323] The motivations of the G20 to enact legislation like Dodd-Frank were commendable.[324] The unintended consequences of Dodd-Frank, however, threaten to erode existing benefits of the financial markets. Given the financial crisis, the global financial markets are better served if the SEC maintains as much oversight as is politically and economically expedient. Through substituted compliance with the European Union, the SEC would uphold the goals of Dodd-Frank while preventing excessive regulation and protecting the competitiveness of the American economy.

317. *See* Coffee, Jr., *supra* note 29, at 1288 (stating that the United States and European Union could "notify other countries (e.g., Japan, Singapore, Hong Kong, Canada, Brazil) as to the minimum requirements that they would require to consider another regulatory regime functionally equivalent").

318. *See id.* Also, other governments may want to build political and economic goodwill with the United States and European Union.

319. *See id.* at 1270 ("Bluntly put, the United States and the EU together have the market power to achieve [global derivatives regulation].").

320. *See supra* notes 307–09 and accompanying text.

321. *See supra* note 163 and accompanying text.

322. *See supra* Part II.C.

323. *See supra* note 1 and accompanying text.

324. *See* Coffee, Jr., *supra* note 29, at 1273.