2012

International Regulatory Arbitrage Resulting from Dodd-Frank Derivatives Regulation

Benjamin M. Weadon

Follow this and additional works at: http://scholarship.law.unc.edu/ncbi

Part of the Banking and Finance Law Commons

Recommended Citation
Available at: http://scholarship.law.unc.edu/ncbi/vol16/iss1/9

This Notes is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Banking Institute by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
International Regulatory Arbitrage Resulting From Dodd-Frank Derivatives Regulation

I. INTRODUCTION

Warren Buffett made the prescient observation in the 2002 Berkshire Hathaway Inc. Annual Report that "derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." While this comparison between over-the-counter (OTC) derivatives and weapons of mass destruction was certainly prophetic in terms of the massive losses caused by derivatives trading in the 2008 financial crisis, the analogy also applies from a regulatory standpoint. Like their government cohorts at the State Department who have recognized the essential need for global cooperation in the fight against the spread of weapons of mass destruction, the Securities and Exchange Commission and the Commodity Futures Trading Commission are now faced with the similar challenge of harmonizing regulatory standards with other jurisdictions to give proper effect to the recent overhaul of OTC derivatives markets regulation.

Following the implosion of global financial markets and the unprecedented intervention of United States financial regulators to miti-
gate the fallout from financial meltdown,\(^5\) Congress initiated a complete overhaul of the U.S. financial regulatory regime with the highly anticipated Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) on July 21, 2010.\(^6\) Title VII of Dodd-Frank focuses exclusively on remediying a host of problems surrounding the previously unregulated OTC derivatives products that wreaked havoc on major financial and insurance industry companies including Lehman Brothers and American International Group (AIG).\(^7\)

Overall, Title VII endeavors to reduce the systemic risks posed by opaque derivatives contracts by mandating significant changes to OTC derivatives trading.\(^8\) The overhaul makes several important changes: requiring certain derivatives trades to be executed on exchanges, introducing a bifurcated OTC derivatives oversight authority for the SEC and CFTC, as well as imposing central clearing on many OTC derivatives contracts to mitigate counterparty credit risks.\(^9\) Additionally, Title VII calls for the implementation of rules governing the collection and posting of margin requirements for any swaps that are not cleared through a third party.\(^10\)

Congress presumably had the best of intentions in passing Title


\(^8\) See Wall Street Transparency and Accountability Act, 124 Stat. 1641.

\(^9\) See id.; Memorandum by Maurine R. Bartlett et al., Cadwalader Wickersham & Taft LLP, The New Scheme for the Regulation of Swaps, with Appendices on Retroactivity, Special Entities and Tax, Under the Dodd-Frank Wall Street Reform and Consumer Protection Act 1 (July 20, 2010), http://www.cadwalader.com/assets/client_friend/072010_DF7.pdf; Aline van Duyn & Michael Mackenzie, Regulation: Pressures Mounting over Derivative Clearing, FIN. TIMES, Nov. 2, 2010, http://www.ft.com/intl/cms/s/0/ae8d7872-e607-11df-9cdd-00144feabdc0.html#axzz1mO7CyPoQ ("Clearing puts a third party in the middle of every trade, which means the risks and costs of defaults are absorbed by the clearing-house members.").

VII of Dodd-Frank and getting out in front of other major international regulators. However, there are serious questions about the risks of "regulatory arbitrage" resulting from the lack of international harmonization of regulations for OTC derivatives markets. Assuming that Title VII is fully implemented as it is written and the current joint regulatory rules proposals concerning margin requirements are adopted, there is a very real possibility that the exploitation of "regulatory arbitrage" opportunities created by the first-mover position of the United States will: (1) place U.S.-based banks at a competitive disadvantage with their non-U.S. competitors; and (2) increase the global risk posed by OTC derivatives as origination and trading migrates to jurisdictions with less burdensome regulations.

Part II of this note examines the debate over the utility of OTC derivatives products and why they have the potential to surreptitiously torpedo the financial system. Then, Part III assesses the particular Dodd-Frank provisions that are likely to foster regulatory arbitrage opportunities and competitive imbalances for affected financial institutions when compared with the broadly similar European Union proposal for derivatives reform known as European Market Infrastructure Regulation (EMIR). This note concludes by suggesting that U.S. regulators should carefully consider the competitive disadvantages that could result for U.S.-based financial services companies, as well as the potential for off-shore derivatives risk concentration, before committing to a derivatives regulation regime that does not account for extraterritorial regulatory positions.

11. Frank Partnoy, Financial Derivatives and the Costs of Regulatory Arbitrage, 22 J. CORP. L. 211, 211 (1996-1997) ("Regulatory arbitrage refers to financial transactions designed to reduce costs or capture profit opportunities created by differential regulations or laws.").
13. See infra Part II.
14. See infra Part III.
15. See infra Part IV.
II. THE BENEFITS AND RISKS OF DERIVATIVES CONTRACTS

A. Derivatives Contracts

Derivatives can be categorized into three distinct types of contracts. The first category of derivative contracts are standardized, exchange-traded derivative arrangements commonly known as “listed derivatives or futures.” The other two categories of derivative contracts are OTC derivatives or “swaps” and “cleared derivatives.” These contracts are privately bargained, highly customizable financial contracts that directly transfer risk between the two parties to the arrangement. Neither OTC derivatives nor “cleared derivatives” are traded on exchanges. The only salient difference between straight OTC derivatives and “cleared derivatives” is that “cleared derivatives”, similar to “listed derivatives”, are processed through a central clearing party that acts as an intermediary between the two parties to the derivative contract.

Although exchange-traded derivatives greatly reduce the risk of counterparty default and provide market participants with greater transparency, these lower risk products are traditionally much less popular.

17. Listed derivative products are traded on a centralized exchange and cleared with a central counterparty. The significant difference between listed derivative and OTC derivatives is that listed derivatives, unlike OTC derivative products, are not customizable to fit the precise risk management needs of the derivative participant. See id.
18. See id. (using the term “swap” interchangeably with “OTC derivatives” although swaps can technically include forwards and warrants as well).
19. See id.
20. See id.
21. See id.
22. See id.
23. In the exchange-traded derivatives market, parties are subject to a margin requirement that provides a safety net for unexpected changes in the solvency of the other party. Over-the-counter derivative contracts currently do not have a margin requirement, or a centralized counterparty to spread the risk of default across multiple parties. See Thomas Lee Hazen, Disparate Regulatory Schemes For Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance, 24 ANN. REV. BANKING & FIN. L. 375, 428-49 (2005); Product Descriptions, supra note 16; Denise Bedell, Exchange-traded Derivatives Prove Their Worth, GLOBAL FIN., June 2009, available at http://www.gfimag.com/archives/100-june-2009/1823-features-exchange-traded-derivatives-prove-their-worth.html#axzz1Ze9bph24 (explaining a recent resurgence in the number of
than OTC derivatives.\textsuperscript{24} Unlike exchange-traded derivatives, which feature highly standardized contracts applicable to a relatively limited range of goods,\textsuperscript{25} OTC derivatives provide risk managers with flexibility to design an agreement tailored to the specific needs of their organization. These customized agreements allow for the creation of an original risk-transfer product based on an exact dollar value, interest or currency rates, and the maturity date desired by the parties.\textsuperscript{26} Additionally, prior to the passage of Dodd-Frank, OTC derivatives operated outside the purview of financial regulators and were not subject to the application of margin requirements that apply to exchange-traded derivatives.\textsuperscript{27}

The relative advantages offered by OTC derivatives over exchange-traded derivatives are also accompanied by significant risks.\textsuperscript{28} Since most OTC derivatives transactions are settled between the parties rather than through a centralized clearinghouse,\textsuperscript{29} each party is exposed to the risk of default by their contractual counterparty.\textsuperscript{30} For exchange-traded derivatives, the various exchanges provide a de facto guarantee of the performance of the contract.\textsuperscript{31} For OTC derivatives contracts, there is no guarantee of performance beyond the creditworthiness of the direct counterparty.\textsuperscript{32} This direct credit exposure arrangement has the ability to cause a wave of defaults as the inability of one institution to exchange-traded derivatives participants by noting “the reason for these figures becomes clearer when considering where much of the value lies in the exchange-traded product: transparency. With counterparty risk of prime concern to corporates in a post-Lehman world, transparency throughout any and every financial trade is essential.”).


\textsuperscript{25} See, e.g., \textit{CME Group at a Glance}, \textit{CME GROUP}, http://www.cmegroup.com/company/history (last visited Dec. 28, 2011) (outlining the range of standardized, exchange-traded derivatives products offered by one of the world’s leading derivative marketplaces).

\textsuperscript{26} See \textit{ROBERT W. KOLB, FINANCIAL DERIVATIVES} 133 (1993).


\textsuperscript{28} See \textit{KOLB, supra} note 26, at 133.

\textsuperscript{29} \textit{BANK FOR INT’L SETTLEMENTS, OTC DERIVATIVES: SETTLEMENT PROCEDURES AND COUNTERPARTY RISK MANAGEMENT} Foreword (Sept. 1998), available at http://www.bis.org/publ/cpss27.htm (finding that “the vast majority of OTC transactions are settled bilaterally between the counterparties, rather than through clearing houses.”).

\textsuperscript{30} See \textit{KOLB, supra} note 26, at 133.

\textsuperscript{31} See \textit{id}.

\textsuperscript{32} See \textit{id}.
meet its derivative contracts could rapidly cause downstream institutions to default on their payment obligations.33

B. The Benefits

It is quite ironic that derivatives, widely scorned as a core contributor to the financial crisis of 2008, are financial instruments fundamentally aimed at managing and transferring risk.34 At the most basic level, an OTC derivative is a financial agreement between two parties to exchange something of value at a designated time in the future based on the change in value of an underlying asset or the mere occurrence of a predetermined event such as a creditor default.35 The underlying variable, which ultimately determines the nature and value of the derivative contract, could range from interest rates to the amount of snow present at a specific ski resort.36

The enterprise-level benefit of derivatives contracts is their unique ability to manage risks that could not be controlled through any other financial mechanism.37 For instance, suppose an institutional fund manager anticipates receiving $100,000 to invest in equities in six months.38 If the fund manager were to hold out for the entire six-month period before receiving the capital, the fund would be exposed to the uncertain risk posed by changes in equity valuations during the waiting period. However, utilizing a financial derivative product known as an equity index swap contract,39 the fund manager is able to lock into an

34. See D’Souza et al., supra note 2, at 477.
35. See Product Descriptions, supra note 16.
36. The most common types of OTC derivatives include interest rate contracts, equity-linked contracts, commodity contracts, and credit default swaps. Nonetheless, the underlying variable that the derivative contract can refer to is limited only by the imagination of the contracting parties. For instance, a ski resort might enter into a swap arrangement based on the amount of snowfall measured at the ski resort to hedge against a decrease in visitors and ensure positive cash flow in the event of low snowfall levels. See Partnoy, supra note 11, at 216.
37. See KOLB, supra note 26, at 17.
38. See id. at 11-12.
39. For an equity index swap, at least one of the two contracting parties payment obligation is determined by the value of an equity index. This type of swaps product can be used to gain the benefits of a direct equity index transaction without actually making an investment in the index. See Don M. Chance, Equity Swaps and Equity Investing 2 (La. State
exposure to potential upward swings in the price of the underlying index six months before the investable capital is available. The equity index swap product allows the fund manager to guarantee an immediate exposure to movements in the targeted index. This sort of transaction typifies the unique advantage of derivatives products as it allows prudent users to take investment positions that would otherwise be unavailable.

C. The Risks

Derivatives can be utilized in an effective manner by financial institutions to hedge risk and prevent lending losses. However, a particular category of derivatives known as OTC derivatives or "swaps" contracts, entered into frequently by financial institutions, is accompanied by significant institution-level and system-wide risks. On the one hand, OTC derivatives constitute a vast majority of the over $600 trillion global derivatives market and are strongly favored by parties

---

40. See KOLB, supra note 26, at 11-12.
41. See id. at 17.
42. See Alan Greenspan, Chairman, Fed. Reserve Bd., Remarks Before the Council on Foreign Relations: International Financial Risk Management, (Nov. 19, 2002), http://www.federalreserve.gov/boarddocs/speeches/2002/20021119/default.htm (“More recently, instruments that are more complex and less transparent—such as credit default swaps, collateralized debt obligations, and credit-linked notes—have been developed and their use has grown very rapidly in recent years. The result? Improved credit-risk management together with more and better risk-management tools appear to have significantly reduced loan concentrations in telecommunications and, indeed, other areas and the associated stress on banks and other financial institutions. More generally, such instruments appear to have effectively spread losses from defaults by Enron, Global Crossing, Railtrack, WorldCom, Swissair, and sovereign Argentinian credits over the past year to a wider set of banks than might previously have been the case in the past, and from banks, which have largely short-term leverage, to insurance firms, pension funds, or others with diffuse long-term liabilities or no liabilities at all.”).
43. Defining systemic risk as “[t]he risk that a default by one market participant will have repercussions on other participants due to the interlocking nature of financial markets. For example, Customer A’s default in X market may affect intermediary B’s ability to fulfill its obligations in Markets X, Y, and Z.” See A Guide to the Language of The Futures Industry, COMMODITIES FUTURES TRADING COMMISSION, http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_s (last visited Sept. 20, 2011).
44. See D’Souza et al., supra note 2, at 491.
seeking to manage risk. However, these customized OTC derivatives contracts also represent a threat to the economy as a whole if they are left wholly unregulated as they were prior to the passage of Title VII of Dodd-Frank.

An example of the propensity for OTC derivatives to result in a cascading wave of defaults, massive financial losses, and paralyzed credit markets is the global financial crisis of 2008. As the housing market thrived from 2000 to 2006 due to low borrowing costs and easily accessible credit, financial institutions sold the newly minted mortgages to be packaged into a once popular form of asset-backed debt security known as collateralized mortgage obligation (CMO). This allowed financial institutions to raise funds for additional mortgages and distance the institution from the risk associated with the mortgages it originated.

A CMO is a debt security composed of a portfolio of mortgage-backed securities. The CMO receives cash flows from the repayment of a pool of mortgage debt. In the low interest environment of the time, many institutional investors were attracted to the higher returns offered by CMOs when compared to more traditional collateralized debt obligations whose returns were based on corporate bond payments. However, the investors' underlying assumption that housing prices would continue to rise and that subprime borrowers would

45. The Bank for International Settlements reports that, as of December 2010, the notional amounts outstanding for over-the-counter derivatives in Switzerland and the G10 countries was $601,048 billion. See BANK FOR INT'L SETTLEMENTS, supra note 24, at A131 tbl. 19. The report also states that the notional principal of derivative financial instruments traded on organized exchanges as of June 2011 was $30,114.6 billion. See id. at A136 tbl. 23A. Based on this report, over-the-counter derivative make up 95.22 percent of the overall derivative marketplace. See id.

46. See D'Souza et al., supra note 2, at 491.
47. See Duffie, supra note 33, at 5-6.
48. See D'Souza et al., supra note 2, at 488.
49. See id. at 485-86.
50. See id. at 487.
51. See Duffie, supra note 33, at 5.
52. See id.
54. "The term 'subprime' refers to the credit characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics
be able to fulfill their mortgage obligations proved to be fatally flawed as the housing "bubble" burst in 2007. The once highly attractive mortgage-backed securities were rendered worthless as the cash flow from the underlying mortgages quickly dried up.

Some sophisticated CMO investors were not totally unaware of the risks posed by mortgage default, and took steps to hedge their default risk exposure by utilizing a popular OTC derivative known as a credit default swap (CDS). The CDS agreement involves a protection buyer paying a periodic premium to a protection seller in return for the protection seller's promise to compensate the protection buyer upon the occurrence of a credit event such as default. This de facto insurance policy for CMOs was sold by large insurance companies such as AIG in such a high volume that the wave of defaults during the housing crisis resulted in some protection sellers being unable to fulfill their CDS payment obligations. The failure of CDS protection sellers, like AIG, to fulfill their obligations then caused significant losses for financial institutions such as Lehman Brothers and Bear Stearns, who relied on CDSs to fulfill downstream derivatives obligations. The dominos of the crisis continued to fall as the derivatives counterparties of major investment banks moved their derivatives positions from weakened investment banks to other derivatives dealers. This "flight to quality" had the effect of withdrawing precious capital from these increasingly illiquid institutions. Ironically, the widespread use of unregulated OTC derivatives, generally intended to mitigate risk exposure, greatly exacerbated the economic impact of the housing crisis.
Title VII of Dodd-Frank attempts to assuage the problems of counterparty credit risk and the lack of transparency in the OTC derivatives market.63 Title VII adopts a bifurcated regulatory structure whereby the Commodities Futures Trading Commission (CFTC) is granted regulatory authority over “swaps” and participants in the swaps market, and the Securities Exchange Commission (SEC) is given authority over “security-based swaps” and participants in the security-based swaps market.64 The legislation seeks to achieve its goals of increasing swaps market transparency and reducing systemic risk in financial markets by requiring: (1) either the divestiture or spin off of derivatives activities to an affiliated company for banks;65 (2) with limited exceptions, the central clearing and exchange trading of OTC derivatives;66 (3) the imposition of capital requirements for all registered swap entities67 and margin requirements for all swaps that are not cleared by a central clearing
house;\(^{68}\) (4) the compilation of detailed books and record keeping in order to provide a clearer window into the derivatives market;\(^ {69}\) and (5) the establishment of position limits for exchange-traded derivatives and derivatives that have a "significant price discovery function."\(^ {70}\)

While the mandates of Title VII represent an admirable step towards reining in the $600 trillion\(^ {71}\) global derivatives marketplace, the fact that the United States jumped ahead of other financial regulators in passing Title VII has created an environment in which differential regulatory standards in major international derivatives markets will prevail absent international harmonization of OTC derivatives regulation.\(^ {72}\)

The unintended consequences of this uneven regulatory playing field include the concentration of derivatives risk in the most hospitable jurisdictions and a competitive disadvantage for U.S. financial firms.\(^ {73}\)

These risks are even more pronounced when one considers that OTC derivatives activity is truly global in nature,\(^ {74}\) and that the overall market value of OTC derivatives in London is forty-three percent of the total OTC derivatives market compared to New York’s twenty-four percent share of the OTC derivative marketplace.\(^ {75}\) A comparison of Title VII of Dodd-Frank and the relatively similar European Union proposal for OTC derivatives regulation, known as the European Market Infrastructure Regulation (EMIR),\(^ {76}\) reveals that even slight variations can

---

68. 7 U.S.C. § 6s. A "major swap participant" is defined as any person who is not a swap dealer but: i) maintains a substantial position in swaps excluding positions held for hedging and risk management and employee benefit plans; ii) has swaps positions that could have a significant detrimental impact on the financial stability of U.S. banks or financial markets; or iii) is financial entity not subject to capital requirements established by Federal banking regulators and maintains a substantial position in a major swap category. 7 U.S.C. §1a.

69. 7 U.S.C. § 6s.

70. 7 U.S.C. § 6a(a).

71. See BANK FOR INT’L SETTLEMENTS, supra note 24, at A131 tbl. 19.


74. See id.

75. See JONES, supra note 7, at 6.

have a significant effect on the risk for regulatory arbitrage and competitive imbalance for U.S. based financial institutions competing in the global marketplace. The three Title VII mandates differing most significantly from the proposed EMIR regulations and posing the greatest risk of regulatory arbitrage and competitive challenges for U.S. financial institutions include: the section 716 swaps push-out rule,\(^77\) the section 731 margin requirements for swaps,\(^78\) and the section 764 requirements for security-based swaps.\(^79\) Additionally, an examination of the possible extraterritorial reach of these particular Title VII regulations to non-U.S. operations of large U.S.-based financial holding companies will guide the discussion of regulatory arbitrage and competitive deficiencies for U.S. banks.\(^80\)

A. Section 716 Swaps Push-Out Rule

The Swaps Push-Out Rule of Title VII, section 716, prohibits any firm defined as a swaps entity\(^81\) from receiving "federal assistance."\(^82\) Federal assistance is defined in section 716(b)(1) to include access to Federal Reserve credit facilities, the Federal Reserve discount

\(\text{lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010PC0484:EN:NOT.}\)

\(^78.\) 7 U.S.C. § 6s (Supp. IV 2010).
\(^81.\) Swaps entity is defined as any firm that qualifies as a "swap dealer", "security-based swap dealer", "major swap participant", or "major security-based swap participant.". 15 U.S.C § 8305. The term "swap dealer" is defined functionally to include any entity that: "i) holds itself out as a dealer in swaps; ii) makes a market in swaps; iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account; or iv) engages in any activity causing the person to be commonly known as a dealer or market maker in swaps . . . ." 7 U.S.C. § 1a. Proposed regulations on the definition of "swap dealer" provide additional criteria for determining whether an institution qualifies as a swap dealer. The proposed regulations state that, generally, swap dealers and security-based swap dealers have the following distinguishing characteristics: i) "tend to accommodate demand for swaps and security-based swaps;" ii) "are generally available to enter into swaps or security-based swaps to facilitate other parties' interest in entering into those instruments;" iii) "tend not to request that other parties propose the terms of swaps or security-based swaps; rather, dealers tend to enter into those instruments on their own standard terms or on terms they arrange in response to other parties' interest;" and iv) "tend to be able to arrange customized terms for swaps or security-based swaps upon request, or to create new types of swaps or security-based swaps at the dealer's own initiative.". \text{See Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant", 75 Fed. Reg. 80174, 80176 (proposed Dec. 21, 2010) (to be codified 17 C.F.R. pt. 240).}
window, and Federal Deposit Insurance Corporation (FDIC) insurance or guarantees. Since all national banks, federal thrifts, state member banks, and state non-member banks and thrifts that offer retail banking services are required to maintain FDIC insurance, the practical effect of section 716 is that all banks qualifying as swaps entities will be forced to either cease their non-exempt OTC derivatives business or create a separately capitalized affiliated swap entity pursuant to section 716(c).

Currently, the proposed EMIR OTC derivatives regulations do not include a provision equivalent to the Swaps Push-Out Rule. Some national government coalitions such as the Liberal Democrats in the UK coalition government are examining ways to reduce potential taxpayer costs in the world of “too big to fail” and have considered the possibility of a structural separation for certain financial activities. Beyond this reference to a regulation similar to the Swaps Push-Out Rule by the Liberal Democrats in the United Kingdom, there is no indication that the final EU OTC derivatives regulations will require the segregation of swaps activity from primary depository banking institutions.

83. Id.
85. 15 U.S.C. § 8305(c). See also The Lincoln Amendment, supra note 84, at 1.
1. Section 716 Exemptions

In response to high-profile criticism\textsuperscript{89} of the original Senate version of the bill calling for a total prohibition of OTC derivatives activity on the part of federally assisted financial firms,\textsuperscript{90} the final version of the Swaps Push-Out Rule includes noteworthy exemptions that lessen the potential burden on affected banks.\textsuperscript{91} In particular, the section 716(d) provisions exempt certain widely utilized derivatives products such as interest rate swaps,\textsuperscript{92} and swaps referencing assets that banks are permitted to invest in pursuant to section 24 (Seventh) of the National Bank Act.\textsuperscript{93} However, one interesting carve-out from these exemptions is the requirement that CDS transactions must be cleared through a derivatives clearing organization to qualify for the section 716(d)(2) exemption.\textsuperscript{94} Furthermore, the prohibition on certain swaps activity within the depository institution only applies to swaps or security-based swaps that are entered into after the end of the up to thirty-six month transition period outlined in section 716(f).\textsuperscript{95}

The section 716(d) exemptions from the Swaps Push-Out Rule have very significant implications for U.S. financial institutions. For U.S. banks engaged in derivatives activity, the Office of the Comptroller of the Currency (OCC) data from the third quarter of 2011 indicates that exempt interest rates derivatives constitute approximately eighty-one percent of total derivatives notional value.\textsuperscript{96} The report also indi-


\textsuperscript{90} S. 3217, 111th Cong. § 716 (2010).

\textsuperscript{91} 15 U.S.C. § 8305(c) (Supp. IV 2010). See also The Lincoln Amendment, supra note 84, at 6-7.

\textsuperscript{92} 15 U.S.C. § 8305(d)(2).

\textsuperscript{93} Id.; 12 U.S.C. § 24 (Seventh) (2006) (enumerating the assets banks are eligible to invest in).

\textsuperscript{94} 15 U.S.C. § 8305(d)(2)-(3).

\textsuperscript{95} 15 U.S.C. § 8305(e).

cates that exempt foreign currency exchange derivatives account for approximately eleven percent of total notional value. For example, the four commercial banks with the highest derivative exposure by notional value include JPMorgan Chase Bank, NA; Citibank, NA; Bank of America, NA and Goldman Sachs Bank USA. These banks would only have exposure to the Swaps Push-Out Rule for 11.4 percent, 6.5 percent, 9.4 percent, and 1.2 percent of the total notional value of their derivatives portfolios respectively. Thus, these particular exemptions have made the Swaps Push-Out Rule much more tolerable for U.S. commercial banks than they would have been otherwise.

2. Operating Structure Choices

Even with the above mentioned exemptions, if U.S. commercial banks subject to the Swaps Push-Out Rule do not cease their non-exempt swaps activity altogether, these institutions must either: (1) divide their swaps activity between exempt and non-exempt swaps and push the non-exempt swaps into an affiliated entity; or (2) push the entire swaps business into an affiliated entity. Neither of these operational structures is very compelling for covered banks, as they both impose additional costs and organizational headaches that U.S. banks’ European competitors will not be forced to confront.

In the first scenario, an affected U.S. bank would move only its non-exempt swaps activity into a separate affiliated entity that would act as a counterparty for all non-exempt swaps transactions. This restriction would create an uncomfortable scenario for swaps clients of the bank, as customers would now have to deal with two separate legal entities to satisfy all of their swaps needs. The client would sacrifice the efficiencies generated by dealing with a single legal entity including payment and close-out netting. Additionally, the parties would al-

98. OCC THIRD QUARTER 2011 REPORT, supra note 96, at tbl. 3.
99. Id. See also J.P. MORGAN CAZENOVE, supra note 97, at 71.
100. See The Lincoln Amendment, supra note 84, at 7-8.
101. See id.
102. See J.P. MORGAN CAZENOVE, supra note 97, at 63.
103. Payment netting reduces the total swaps payments due between counterparties to a single net payment. Simply put, if Counterparty A owes Counterparty B $100.00 and Coun-
so have to undertake significant documentation expenses to account for the re-arrangement of the transactional relationship between swaps counterparties. One distinct advantage of this divided operational structure is that the cost of funding the smaller affiliated entity will likely be much lower than capitalizing a completely separate affiliated entity for all swaps transactions.

The second approach involving the divestiture of the entire swaps business would require the institution to seek funds for an affiliated entity at market rates for the cost of capital rather than the below market cost of capital enjoyed by banks with access to the Federal Reserve discount window. This cost of capital issue is the strongest factor vitiating against a total push-out of the entire swaps business into an affiliated entity. Although the operational hurdles presented by the dual swaps arrangement would be avoided under this option, the decreased profit margins for swaps activities resulting from the increased cost of capital and capital requirements for swaps dealers make this option much less attractive for these bottom-line oriented organizations. Irrespective of which organizational structure is embraced by banks impacted by the Swaps Push-Out Rule, the swaps customers will now be engaging in swaps transactions with smaller, less capitalized institutions. Additionally, the Swaps Push-Out Rule shifts fairly risky

---

104. Close-out netting allows for a single payment to settle final amount owed between counterparties following default by one of the counterparties. See Product Descriptions, supra note 16.

105. Letter from Barclays Bank PLC et al., to David A. Stawick, Sec’y, Commodities Futures Trading Comm’n et al. (Jan. 11, 2011), 2011 WL 403237.

106. See J.P. MORGAN Cazenove, supra note 97, at 66.

107. See id. at 66-67.

108. See The Lincoln Amendment, supra note 84, at 8.

109. Pursuant to section 731 of Dodd-Frank, the CFTC is required to adopt capital requirements for non-bank subsidiaries of bank holding companies that qualify as swap dealers or major swap participants. The currently proposed rule would subject these non-bank subsidiary swap dealers and major swap participants to the capital adequacy guidelines applicable to the bank holding company under 12 CFR part 225. Of course, unlike the bank holding company, the affiliated entity would not have the benefit of accessing the discount window to fulfill the capital requirement. Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802, 27,802 (proposed May 12, 2011) (to be codified at 17 C.F.R. pts. 1, 23 and 140).

110. See J.P. MORGAN Cazenove, supra note 97, at 65-66.

111. See Letter from Laura J. Schisgall, Managing Dir & Senior Counsel, Societe Generale, to David A. Stawick, Sec’y, Commodities Futures Trading Comm’n et al. (Feb. 18, 2011), 2011 WL 2208257.
swaps transactions from the "best capitalized and most highly rated entity" in the bank holding company to an affiliated organization that has a limited asset base outside of the swaps business itself.\textsuperscript{112} It is hard to deny that banks subject to the section 716 organizational reshuffling will face a competitive disadvantage compared to foreign banks not subject to the regulations as they compete for swaps customers on a global scale.\textsuperscript{113}

B. Margin Requirements for Non-Cleared Swaps

Another example of a direct competitive imbalance that U.S.-based firms affected by the Title VII might encounter is the application of a higher margin requirement for non-U.S. swaps transactions compared to the margin requirement applicable to foreign competitors in the local jurisdiction.\textsuperscript{114} Pursuant to section 731 for swaps and section 764 for security-based swaps,\textsuperscript{115} the prudential regulators for banks and other entities that are subject to regulation by a prudential regulator are required to impose minimum initial and variation margin requirements for all swaps transactions that are not cleared through a registered swap clearing organization.\textsuperscript{116} In setting margin requirements for non-cleared swaps, the SEC, CFTC, and the prudential regulators are instructed to impose requirements that ensure the "safety and soundness of the swap dealer or major swap participant."\textsuperscript{117} Additionally, regulators are instructed to develop margin requirements that are "appropriate for the risk associated with non-cleared swaps held as a swap dealer or major swap participant."\textsuperscript{118} The proposed rules released by the prudential regulators vary the amount of initial\textsuperscript{119} and variation\textsuperscript{120} margin that is re-

\textsuperscript{112} See id.
\textsuperscript{113} See The Lincoln Amendment, supra note 84, at 8.
\textsuperscript{114} Letter from Bank of America Corp. et al., to Elizabeth Murphhy, Sec'y, Sec. Exch. Comm'n et al. (Feb. 22, 2011), 2011 WL 2208296.
\textsuperscript{115} 7 U.S.C. § 6s(e)(2) (Supp. IV 2010).
\textsuperscript{116} 7 U.S.C. § 6s(e)(2)(A).
\textsuperscript{117} 7 U.S.C. § 6s(e)(3)(A)(i).
\textsuperscript{118} 7 U.S.C. § 6s(e)(3)(A)(ii).
\textsuperscript{120} Variation margin is the posting of additional funds to adjust for negative market movements. Financial Glossary: Variation Margin, Reuters, http://glossary.reuters.com/index.php?title=Variation_Margin&diff=11341&oldid=11340
quired to be collected depending on the type of counterparties involved in the transaction.\textsuperscript{121} For the purposes of calculating the initial margin requirement, the proposal allows swap entities to utilize either an internal model approved by the applicable regulator or a standardized margin model.\textsuperscript{122} The standardized model calculates the margin requirement as a percentage of the notional amount of the swap.\textsuperscript{123} The applicable percentage assessment varies based on the type of swap and the nature of the counterparties.\textsuperscript{124} The proposed rules also state that the permissible collateral for satisfaction of margin requirements is limited to immediately-available cash, any obligation which is a direct obligation or fully guaranteed obligation of the United States, as well as senior debt obligations of certain government-sponsored entities for initial margin only.\textsuperscript{125} For affected U.S. based financial institutions, the implementation of these proposals will increase the cost of OTC swaps transactions for their derivatives clients and tie up investable bank capital in margin accounts.\textsuperscript{126}

Although the EMIR proposal also contemplates margin requirements for centrally cleared derivatives transactions and swap entities participating in non-cleared swaps,\textsuperscript{127} there is currently no guarantee that the margin requirements will be equally stringent.\textsuperscript{128} Also, even with the extension of exemptive relief from swaps regulation until July

\textsuperscript{121} Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564, 27,567 (proposed May 11, 2011) (to be codified at 12 C.F.R. pts. 4, 5, 7, 8, 28, and 34).

\textsuperscript{122} See id. at 27,567-68.

\textsuperscript{123} See id.

\textsuperscript{124} See id. at 27,568; Memorandum by Davis Polk & Wardwell LLP, Regulators Propose Swap Margin and Capital Rules (Apr. 14, 2011), http://www.davispolk.com/files/Publication/a4c40ee1-b508-440a-a806-0039b0dd1d78/Presentation/PublicationAttachment/1fcc4a70-1ff-4053-b015-0441b700116e/041411_Davis_Polk_Swap_Capital_Margin_Rules.pdf [hereinafter Davis Polk Memo].

\textsuperscript{125} Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. at 27,578.

\textsuperscript{126} See, e.g., Letter from Bank of America Corp. et al., supra note 114 (referencing the risk of competitive disadvantage resulting from heightened transaction costs relative to uncovered foreign competitors); Davis Polk Memo, supra note 124, at 2 (noting that the prohibition on reinvesting segregated margin funds for non-cleared swaps transactions between two swap entities could impose a "large opportunity cost" for banks).


\textsuperscript{128} See Barry Zubrow Testimony, supra note 72, at 16.
16, 2012 by the CFTC, it is likely that U.S. margin regulations will be effective prior to the implementation of EU margin regulations, which industry experts do not expect to be implemented until 2013 at the earliest.

Considering the distinct possibility for disparate substantive standards and implementation timelines for margin requirements, one of the most striking aspects of the prudential regulators' proposed rules on margin requirements for non-cleared swaps is the extraterritorial reach of the requirements. The proposed rules apply to all swaps transactions of all non-U.S. subsidiaries and affiliates of any U.S. entity. The margin rules only exempt from coverage "foreign non-cleared swaps" and "foreign non-cleared security-based swaps." A "foreign non-cleared swap" is defined as a swaps transaction between a "foreign covered swap entity" and a foreign counterparty. A "foreign covered swap entity" is defined as a swap entity that is:

1) Not a company organized under the laws of the United States or any State; 2) Not a branch or office of a company organized under the law of the United States or any State; 3) Not a U.S. branch, agency, subsidiary of a foreign bank; and 4) Not controlled, directly or indirectly, by a company that is organized under the laws of the United States or any State.

As a result of this narrow exception from coverage, U.S. financial holding companies with domestic and overseas subsidiary swaps businesses servicing foreign clients, such as JP Morgan Chase & Co., will be placed at a competitive disadvantage compared to European banks that would qualify as exempt foreign swap entities. If the cur-
rent proposed rules are implemented, and the E.U. does not implement margin requirements that are more stringent or equal to the U.S. margin requirements, many industry experts believe the U.S. banks will not be able to compete in the global market and will essentially be forced to concede this book of business to European and Asian competitors.¹³⁸

For instance, a hypothetical Dutch pension fund seeking to engage in a swaps transaction would be forced to post margin with U.S. banks but could avoid the burden altogether in a transaction with a non-U.S. bank during an anticipated lag period between U.S. and E.U. effective dates.¹³⁹ Additionally, this hypothetical Dutch pension fund could also obtain reduced margin requirement in transactions with non-U.S. banks if the eventual E.U. margin requirements are less stringent than those for U.S. banks.¹⁴⁰ In this scenario, a potential foreign swaps customer will presumably shift its swaps activity to the entity offering a similar swaps contract with lower transaction costs.¹⁴¹ Overseas swaps activities are vitally important within the framework of the global integrated client model employed by large U.S.-based financial holding companies.¹⁴² A disparate and uneven international regulatory stance on margin requirements for non-cleared swaps in the two largest markets for OTC derivatives would have negative competitive and bottom-line implications for already weakened U.S. financial holding companies.¹⁴³

C. Extraterritoriality and Global Competitiveness Implications

The magnitude of the regulatory arbitrage risks and competitive disadvantage problems associated with disparate global derivatives standards cannot be fully ascertained until the SEC and CFTC make


¹³⁹. The Financial Stability Board reports that the European Union will not have legislation in place before 2013 and that “most other jurisdictions have not yet made basic decisions about regulatory measures, including whether any regulatory action will be taken.” Daniel Pruzin, FSB Says G-20 Countries Falling Behind In Implementing Controls on OTC Markets, BANKING DAILY (BNA). Oct. 12, 2011, available at http://new.bna.com/bldn/display/batch_print_display.adp?searchid=15944080.

¹⁴⁰. See Barry Zubrow Testimony, supra note 72, at 16.

¹⁴¹. Letter from Bank of America Corp. et al., supra note 114.

¹⁴². See Barry Zubrow Testimony, supra note 72, at 17 (highlighting the “vital importance” of overseas derivatives to U.S. financial companies).

¹⁴³. See id.
clear the extent to which Title VII mandates will apply to the non-U.S. entities of large U.S. financial holding companies like Bank of America Corporation and JP Morgan Chase & Co. The essential question is whether non-U.S. entities of U.S. financial holding companies will be considered swap dealers under section 721 or security-based swap dealers pursuant to section 761. If these off-shore entities qualify as swap dealers, then they would need to register with either the SEC or CFTC, and would be subject to the full gamut of Title VII derivatives regulations that their foreign-based competitors could avoid entirely.

In making this determination, the SEC, CFTC, and U.S. bank regulators find themselves in a dilemma of sorts. If they decide to apply Title VII derivatives regulation on an extraterritorial basis, then global U.S.-based financial holding companies would be placed at a distinct competitive disadvantage to foreign competitors who do not have to deal with the cost burdens of dual U.S. and foreign regulatory compliance.

On the other hand, in the absence of equally stringent derivatives regulations in foreign trading markets, the exemption of non-U.S. subsidiaries from the mandates of Title VII would represent a significant loophole in the new derivatives regulatory regime. In addition to the argument that extraterritorial application of Title VII will result in a competitive disadvantage for U.S.-based participants in the global derivatives market, potentially impacted organizations also argue that the statutory language vitiates the application of Title VII to non-U.S. derivative operations. Section 722(d)(i) and section 772(b) establish limitations on the extraterritorial application of Title VII regulations for swaps and security-based swaps respectively. For swaps, section 722(d) states that the rules promulgated in Title VII:

144. See Letter from Bank of America Corp. et al., supra note 114.
145. See id.
146. See id.
147. See id.
149. See Letter from Bank of America Corp. et al., supra note 114; Letter from Kenneth E. Bentsen, Jr., Exec. Vice President, Sec. Indus. and Fin. Mkts. Ass’n, to David A. Statwick, Sec’y, Commodities Futures Trading Comm’n et al. (Feb. 3, 2011), 2011 WL 2208318.
shall not apply to activities outside the United States unless those activities: 1) have a direct and significant connection with activities in, or effect on, commerce of the United States; or 2) contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of this Act that was enacted by [Title VII].

Similarly, for security-based swaps, section 772(b) prohibits extraterritorial application of Title VII to activities of individuals transacting business “without the jurisdiction of the United States” unless the individual is in violation of a regulation intended to prevent the evasion of Title VII’s mandate. Potentially affected U.S.-based financial institutions contend that these extraterritorial limits represent a Congressional intent to preserve the established principle that, absent a clear intent to the contrary, U.S. legislation is not meant to be effective outside the territorial jurisdiction of the United States. Furthermore, they argue that the mere connection of their foreign swap operations with the U.S.-based financial holding company does not satisfy the “direct and significant” connection or effect test for extraterritorial application of Title VII considering that these affiliates agree they will limit their activity to wholly non-U.S. transactions with non-U.S. counterparties. On the other side of that contention, a U.S.-based financial holding company is responsible for losses accruing to its subsidiary entities, and thus these foreign swap operations do have a direct effect on U.S. commerce and would satisfy the criteria for extraterritorial application of Title VII. For instance, a strong counterpoint to the argument that U.S. banks and financial companies should be exempted from oversight when dealing with non-U.S. clients is the fact that a majority of AIG’s credit default swap counterparties during the financial crisis were for-

---

151. 7 U.S.C. § 2(i)(1)-(2).
152. 15 U.S.C. § 78dd(c).
154. See Letter from Bank of America Corp. et al., supra note 114.
eign bank clients of AIG. Certainly, these AIG swap contracts with foreign-based clients severely threatened the stability of the U.S. economy.

Additionally, if the non-U.S. swaps operations are exempted from Title VII regulations, there is a distinct possibility that U.S.-based financial holding companies would shift the bulk of their swaps trading activity to more hospitable jurisdictions. This could potentially result in the concentration of financial risk in jurisdictions with the most favorable regulatory regime as companies exploit the regulatory arbitrage opportunity presented by disparate regulations. This result would clearly be counter to Title VII's primary goal of reigning in the risks associated with OTC derivatives.

IV. CONCLUSION

An attractive solution to the competitive imbalance and risk concentration threats posed by regulatory arbitrage is ensuring that material EU and U.S. derivatives regulations are harmonized. Even some of the leading political proponents of more stringent U.S. derivatives regulations have called for the international harmonization of derivatives regulations after considering the "significant competitive disadvantage for U.S. firms operating globally" that would result from an uneven regulatory playing field. Also, leading U.S. regulators including Treasury Secretary Geithner have publicly acknowledged and embraced the need for alignment of derivatives regulations with the European Union. The most sensible regulatory approach would be to proactively

157. Id.
159. Michael J. McFarlin, Avoiding Race To Bottom On Regs, FUTURES MAGAZINE (July 1, 2011), http://www.futuresmag.com/Issues/2011/July-2011/Pages/Avoiding-race-to-bottom-on-regs.aspx ("A big concern is regulatory arbitrage as non-U.S. jurisdictions potentially can undercut our new and tougher standards.").
161. Timothy Geithner, Sec'y, Dep't of the Treasury, Remarks to the International
work with foreign regulators to ensure regulatory parity on the key items of derivatives reform.\textsuperscript{162} This would enable the United States to maintain the basic framework of the much-needed Title VII derivatives legislation without risking a destructive "race to the bottom" or a competitive disadvantage for U.S. firms.\textsuperscript{163} Although the end result of international harmonization efforts hangs in the balance, it is clear that removing the attendant risks of regulatory arbitrage will be integral to the success of Title VII and the long-term health of the U.S. financial services industry and the U.S. economy as a whole.

\textbf{Benjamin M. Weadon}