THE REGULATOR WHO CAN STOP THE NEXT AIG

by: Wallace C. Turbeville

CFTC Chairman Gary Gensler has often said that weak rules on regulatory jurisdiction across borders could blow a hole in the bottom of financial reform. He is right. In a recent speech on the subject, he said: "All of these common-sense reforms Congress mandated, however, could be undone if the overseas guaranteed affiliates and branches of U.S. persons are allowed to operate outside of these important requirements." Imagine what it would do to financial reform if banks could avoid regulation by transacting derivatives through offshore affiliates that they fully guarantee and whose profits and losses they absorb. What an absurd outcome!

A three-cornered fight over cross border jurisdiction has become so complicated and intense that the Chairman has but one rational option: allow the US rules to go into effect without any guidance on how jurisdictional conflict or overlap will be resolved. That will stifle the bickering in a New York minute.

Each of the big US banks operates through thousands of affiliates for the specific purpose of optimizing regulatory and tax effects on profitability. They pick the rules that maximize profits. Gensler should know about this. He had the job of managing the process at Goldman Sachs.

Derivatives trading transcends our concepts of sovereign jurisdiction. These contracts are, to state the obvious, "derivative." They are not assets or actual interests in assets that are connected to a physical location. Rather they are contractual promises that synthesize the consequences of ownership of securities, commodities and currencies. These contracts are struck in cyberspace. Physical location of individuals who make the decision to execute a contract, or of servers who execute contracts pursuant to complex algorithms as if they were derivatives robots, makes no difference. There is no meaningful connection to a tangible asset or a company or government. A trader of the same derivative can sit in New York or London or, for that matter, Tahiti. All that is required is the technology to support the trader (robot or human) and the restaurants and entertainment to satisfy lifestyle needs.

Major European and Asian jurisdictions are well on their way to adopting reform regulation. The question is how these regulations and the US rules fit together. Are there any gaps? Can banks game the jurisdictions without violating rules, as Chairman Gensler once did?

As a practical matter, this will depend on how the CFTC chooses to approach its own jurisdiction. The Dodd-Frank Act wisely ignored technicalities like where a company is organized and where individuals maintain their desks. The Act extends jurisdiction to any activities that have a significant effect on US commerce.

Some months ago, the CFTC issued a proposed guidance on how it would approach multi-jurisdictional issues. At the same time it issued an exemptive order, a policy statement of general applicability that said that it would allow banks and other derivatives traders to transact freely while the cross-jurisdictional issues were sorted out. On July 12, the exemptive order expires. In the interim, instead of working the issues out, other jurisdictions, primarily the Europeans, have complained publicly about the CFTC's approach, generally saying that the US regulator has overreached. The banks have also complained, warning gravely of burdensome and multiple levels of regulation.

The problem is that all of this has befuddled members of Congress and the press and has made regulators other than Gensler weak in the knees for no reason. As Shakespeare said "it is a tale… full of sound and fury, signifying nothing."

The Dodd-Frank Act had it right. Jurisdiction is properly broad and the regulators in the various nations should work it out. That is precisely what has happened. Most of the differences have been worked out. These differences are in the form of conflicting rules and overlapping rules, and the conflicts have been agreed upon. What remains is the basic problem of a US party transacting with a foreign party where rules overlap. The obvious answer is that the most conservative, meaning safest, set of rules should prevail. That does not satisfy the banks who dream of a world in which the weakest rules govern. And the foreign jurisdictions realize that the US rules, which are generally safer, will often displace their own.

At the height of the controversy, the SEC published cross border rules for the derivatives markets under its jurisdiction. These rules were touted as a "middle way" that had the prospect of pleasing everyone. They raised the question whether the CFTC's guidance should simply align with the SEC approach. However, the statutory jurisdiction of the SEC is narrower than the CFTC's, and for good reason. The SEC covers only a small sliver of the derivatives markets, credit default swaps that name a single company or government as the referenced credit. They are traded far less traded than credit default swaps on multi-credit indices and represent less than 5% if the swaps market.

Again, the rationality of Dodd-Frank provides the answer. Comparing the SEC's approach with the CFTC's constitutes a false equivalency.

EU officials then threatened to insert the derivatives regulation issue into US/EU trade talks. The aggressiveness of the Europeans should not be allowed to control sensible US policy. Their positions grow out of the complex politics of the EU itself. The British government has recently been threatening a referendum that could pull it out of the EU in favor of an associated status. This gives the UK great leverage and the government has used it to further its banking sector's perceived interest, to be expected since finance represents a huge share of the UK economy. The US should not give in to this convoluted power play.

Chairman Gensler controls the agenda of the CFTC and any action on the expiring exemptive order must be initiated by him. He could accede to compromises that could gut financial reform in order to make everyone happy. Alternatively, he could yield to the temptation to kick the can down the path, simply extending the exemptive order in the hope that a prudent guidance on cross jurisdictional issues might emerge given time.

This issue is far too important to give into these temptations. He has a far better alternative: he could simply allow the exemptive order to expire. If that happens, the 56 rules governing swaps will then apply to all entities and transactions that fall within the broad Dodd-Frank provision. This is not a problem because the CFTC is far ahead of the Europeans and others in adopting rules. For both the banks and the Europeans, some limiting rules are better than none. Therefore, they will both be far more likely to come to a sensible agreement as soon as it is clear that the US will allow their own rules to go into effect broadly.

If Chairman Gensler chooses this path, he will distinguish himself in Washington. While politicians and regulators seems to avoid conflict even if it means not doing the right thing, he will stand out as one who achieves much by simply standing his ground in the cause of the public's interests.

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