

The

AMERICAN



INTEREST

CONTENTS

THE AMERICAN INTEREST • VOLUME V, NUMBER 6, VACATION (JULY/AUGUST) 2010



THE SHAPE OF EUROPA

5 **What Happened to “Europe”?**

Walter Laqueur, Pierre Hassner, Richard Burt, Michael Stürmer, Kurt Volker, Ivan Krastev, Mitchell A. Orenstein and Ana Palacio ponder the fate of a continent in crisis.

25 **A Special Relationship in Jeopardy**

by Eric Edelman

All four pillars of the Anglo-American alliance have been weakened, but its future is still in our hands.

35 **Afghanistan Greened**

by Elizabeth Pond

Guess which German party is most hawkish on the war in Afghanistan.



CAPITALISM, DEMOCRACY & LAW

39 **Dear Mr. Corporation?**

by Robert Reich

Corporations are made of contracts, not people.

44 **Campaign Finance after *Citizens United***

by Mark Schmitt, Richard L. Hasen & Michael J. Malbin

Unpacking the Supreme Court's January bombshell.

58 **Transparency First**

by Raymond Baker

A better way to clean up Wall Street.

66 **Measuring Secrecy**

by John Christensen

The Financial Secrecy Index is a new tool for ranking jurisdictions according to the transparency of their financial markets.

68 **Law as Leverage**

by Heather Lowe

There's a lot more Congress can do to put our financial house in order.

75 **The Wall Street ICEcapades**

by Lucy Komisar

The too-big-to-fail crew pulls off a double axel.





REVIEWS

80 **Strategy Is as Strategy Does**

by Charles Hill

Edward Luttwak's *The Grand Strategy of the Byzantine Empire* eruditely makes the case that such a thing actually existed.

86 **Writing Strategy**

by Edward N. Luttwak

Charles Hill's *Grand Strategy and Literature* surprises and enthralls.

92 **Too Political to Succeed**

by Harold James

What made U.S. banks take such disastrous risks? Not what we've been led to think.

98 **The Logical Insanity of Theodor Geisel**

by Jennifer Hewett

A new life of Dr. Seuss, American icon.

103 **Layard of Nineveh**

by Roger Sandall

The amazing dumb luck of a Victorian romantic gone native.

NOTES & LETTERS

110 **Notes on the State of Black America**

by Nathan Glazer

Perhaps the strangest thing about black America today is how little we talk about it.

117 **The Soft Power of Science**

by Ahmed Zewail

President Obama's Science Envoy and a Nobel laureate in chemistry has an idea for restoring America's image in the Middle East.

120 **Letters to the Editor**

Readers respond to Daniel Kurtzer's "Beyond the Settlements", C. Raja Mohan's "Return of the Raj", and James Kraska's "Northern Exposures."

125 **Vacation Note: Two Funerals and a Meaning**

by Anne Applebaum

The sudden deaths of a British Princess and a Polish President don't have much in common, but the reactions to them do.

128 **Yankee Doodle**



The
AMERICAN INTEREST

EXECUTIVE COMMITTEE

FRANCIS FUKUYAMA, *chairman*

CHARLES DAVIDSON, *publisher & CEO*

WALTER RUSSELL MEAD, *editor-at-large
& director, The American Interest Online*

ELIOT COHEN

JOSEF JOFFE

ADAM GARFINKLE, *editor*

DANIEL KENNELLY, *senior managing editor*

MARK NUGENT, *associate editor*

NOELLE DALY, *assistant editor*

DAMIR MARUSIC, *associate publisher*

KATHERINE HALL, *assistant to the publisher*

ERICA BROWN, MICHELLE HIGH,

editorial consultants

SIMON MONROE, R. JAY MAGILL, JR., *illustrators*

cover design by DAMIR MARUSIC

EDITORIAL BOARD

ANNE APPLEBAUM, PETER BERGER,

ZBIGNIEW BRZEZINSKI, TYLER COWEN,

NIALL FERGUSON, ROBERT H. FRANK,

WILLIAM A. GALSTON, OWEN HARRIES,

G. JOHN IKENBERRY, STEPHEN D. KRASNER,

BERNARD-HENRI LÉVY, SEBASTIAN

MALLABY, C. RAJA MOHAN, ANA PALACIO,

ITAMAR RABINOVICH, ALI SALEM, LILIA

SHEVTSOVA, TAKASHI SHIRAISHI, MARIO

VARGAS LOSA, WANG JISI, RUTH

WEDGWOOD, JAMES Q. WILSON

ADVERTISING & SYNDICATION

DAMIR MARUSIC

damir.marusic@the-american-interest.com

(202) 223-4408

website

WWW.THE-AMERICAN-INTEREST.COM

SUBSCRIPTIONS: Call (800) 362-8433 or visit www.the-american-interest.com. One year (6 issues): \$39 print; \$19 online; \$49 for both. Two years (12 issues): \$69 print; \$38 online; \$98 for both. Please add \$14 per year for print-subscription delivery to Canada and \$33 per year for delivery to addresses outside the United States and Canada. Postmaster and subscribers, send subscription orders and changes of address to: *The American Interest*, P.O. Box 15115, North Hollywood, CA 91615. *The American Interest* (ISSN 1556-5777) is published six times a year by The American Interest LLC. Printed by Fry Communications, Inc. Postage paid in Mechanicsburg, Pennsylvania. ©2010, The American Interest LLC. Application for mailing at periodical pricing is pending in Washington, DC and additional mailing offices. Editorial offices: 1730 Rhode Island Ave. NW, Suite 707, Washington, DC 20036. Tel.: (202) 223-4408. Fax: (202) 223-4489. Email: ai@the-american-interest.com.

A Note from the Publisher

Dear Readers,

Upon the fifth anniversary of the founding of *The American Interest*, we are proud and thrilled to announce that Walter Russell Mead—in addition to continuing with his remarkable online contributions—will act as impresario for up-and-coming talent whom we will introduce on our website (www.the-american-interest.com).

Mr. Mead will also develop other ideas and projects. We hope you will stay tuned over the next few months as we roll out some of this innovation, free from emulation of the latest Internet fads—we'll endeavor to avoid systemic abridgment catering to the supposedly deficient attention spans of online readers.

Another new development is that we are now pre-releasing a certain amount of material on our website if it has particular relevance to the news cycle. For example, from this issue, we posted at *The American Interest Online* an article by Lucy Komisar on May 18, during the thick of the legislative debates on financial reform.

We much appreciate your readership. These are turbulent times in publishing, but as you see we are forging ahead.

With all best regards,

Charles Davidson
Publisher

Location, location, location is key for ICE Trust U.S., a new clearinghouse that trades credit default swaps, the complex financial instruments at the heart of one financial crisis after another, from Lehman Brothers to AIG to Greece.

The Wall Street ICEcapades

Lucy Komisar

As the U.S. Senate recently debated a major financial reform bill in which the credit default swap, a kind of derivative, played a significant part, Senators Carl Levin (D-MI) and Jeff Merkley (D-OR) proposed an amendment to that bill that would have banned banks from proprietary trading. There were a lot of high-rolling bankers who did not want that amendment to pass, because it would have messed up their plans to repatriate foreign profits into the United States, untaxed, by trading in derivatives on their own accounts. The clearinghouse ICE Trust U.S. forms a central part of these plans.

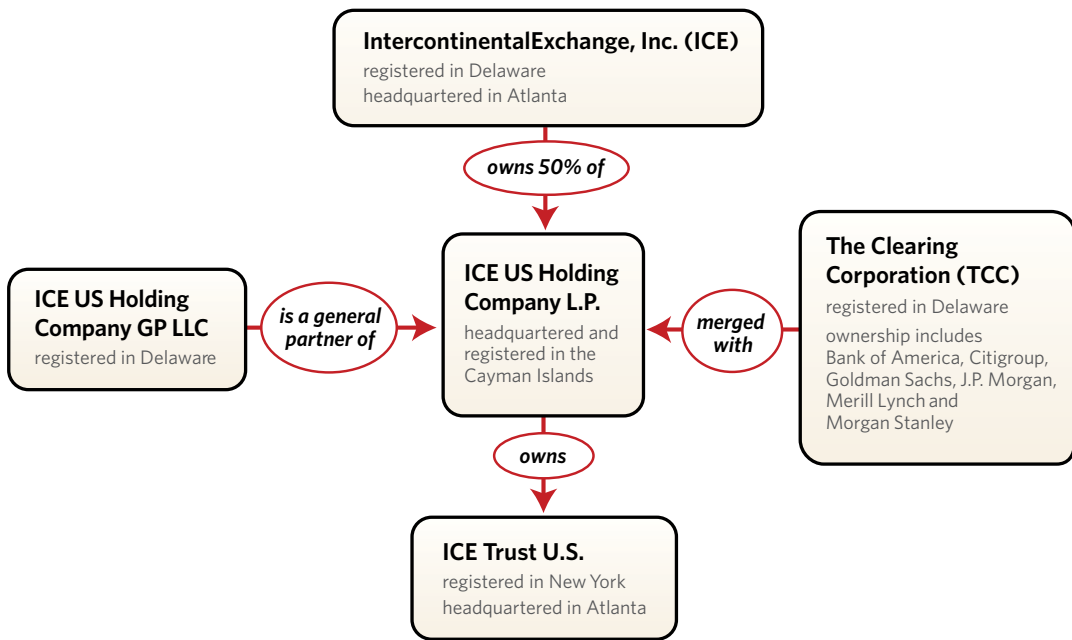
What is ICE Trust U.S., and who owns it? ICE US Holding Co., which was established in 2008 as the parent of ICE Trust U.S., is located in the Cayman Islands. Yet none of the owners of ICE US Holding Co. are based in the Caymans. IntercontinentalExchange, Inc., which owns 50 percent of ICE US Holding, is headquartered in Atlanta, Georgia. Among the other owners of the Caymans company are Citigroup, Goldman Sachs, J.P. Morgan, Merrill Lynch and Morgan Stanley, which are

headquartered in New York. Bank of America, which now owns Merrill Lynch, is based in Charlotte, North Carolina. Deutsche Bank (Frankfurt) and both UBS and Credit Suisse (Zurich) are also part owners.

Derivatives lie close to the heart of the debate over financial reform, yet no one appears to have examined the ICE exchange, whose ownership means it will be the world's main credit default swap clearinghouse; nor has anyone explained how its ownership structure might enrich the banks who own ICE US Holding Co. at the expense of U.S. taxpayers. This is what I propose to do here.

ICE Trust U.S. was created in anticipation of tougher U.S. laws that will force the trading of derivatives into clearinghouses in which prices are made public and the losses of one member are shared with others. The Obama Administration proposed this measure last year, explaining it as a form of self-insurance designed to reduce the odds of another financial company bailout by U.S. taxpayers. The Administration had good reason to focus on derivatives, which are securities based on the value of other securities. They account for \$600 trillion in investment worldwide and include everything from

Lucy Komisar is an investigative journalist who since 1997 has focused on reporting about the offshore bank and corporate secrecy system.



futures and options to complex, one-of-a-kind contracts. ICE focuses on the market for credit default swaps, a form of insurance that protects investors against defaults in the bond market. ICE's member banks account for about 90 percent of the credit default swap market and are thus in position to steer business to ICE and help it capture a leading market share.

Given the nature of its business, there's no obvious reason why ICE has to be owned by a company outside of the United States. Its fledgling rival, a clearinghouse operated by the Chicago Mercantile Exchange, is based in the United States and has no foreign parent. So why is ICE's parent located in the Cayman Islands? Jonathan Short, chief counsel of IntercontinentalExchange Inc., declined to answer this question on the record, but some experts have offered a very plausible explanation. To understand the experts' explanation, however, we first need to know a little tax history.

Before the 1960s, it had been a long-standing rule that U.S. company profits earned abroad are not taxed until they are repatriated. Even before repatriation, however, U.S. corporations could reap economic benefit from foreign subsidiaries' earnings by making them available to the U.S. parent company as investments, loans or guarantees. The Kennedy Administration and Congress tried to put an end to this practice, having decided that such practices were in

substance little different from the parent company's receipt of a dividend. In 1962, Congress enacted Section 956 of the tax code, which said that not just profits but any company funds moved to the United States, including loans, would be taxed.

Clearinghouses such as ICE Trust U.S., which move large sums of money around the world, can run afoul of Section 956 because they collect security deposits, known as margin, from their clients, which tax authorities view as a form of loan. These "loans" can be taxable, depending upon who is doing the trading, where they are trading from and who owns the exchange. For example, some of the banks using the services of ICE Trust U.S. are its U.S. broker-dealer owners doing business through foreign subsidiaries. They include Bank of America/Merrill Lynch, Citigroup, Goldman Sachs, J.P. Morgan and Morgan Stanley. If they use ICE Trust U.S. to buy American credit default swap products, they must deposit money with the clearinghouse as collateral, or margin. If their foreign subsidiaries make the trades for clients, the margin isn't subject to U.S. taxes. But if the banks' foreign subsidiaries use ICE Trust U.S. to trade credit default swaps for themselves, called "proprietary trading", the margin they put in ICE Trust U.S. falls under Section 956. Since those banks are part owners of ICE Trust U.S., this is deemed transferring money from the subsidiary to the

parent in the United States, and it is taxable. This is why it might help to have a pass-through in the Cayman Islands. As a source close to ICE explained:

The only reason a Cayman entity was formed was to have a foreign entity in the chain of ownership. The problem that some of the clearing participants had with this and with our clearing offering was the application of that section of the Internal Revenue code to payments that would be made from their CDS foreign clearing operations through the clearinghouse for marketing purposes and the potential taxation of those payments under Section 956. They were concerned that, because they would have a profit-sharing interest in this U.S. clearinghouse, that it could fall within 956. So the decision was made, 'Let's interpose a foreign entity in the structure.' That way it will fall clearly outside 956. There will be no risk that it could ever apply, and everyone was happy with the structuring.

David Howard, a lawyer and certified public accountant with the Silicon Valley law firm Hoge Fenton, explained further that ICE US Holding Company L.P., Cayman Islands, which owns ICE Trust U.S., is "a blocking company" used to prevent the foreign subsidiary from being deemed as loaning margin to a "U.S. person" (namely, ICE Trust U.S.). "They are loaning the money to a Cayman Islands person", he said. This means that banks can keep their profits abroad and untaxed, but still use them to trade on a U.S. exchange, making investments in U.S. credit default swaps while not paying tax on the collateral placed on the exchange. It's precisely what Section 956 was designed to prevent.

Tax experts say ICE Trust U.S. and its owners benefit from the fact that the IRS and other regulators have very different ways of looking at the map. The Caymans offshore structure is legal: Both the New York Federal Reserve Bank and the New York Banking Department approved it. New York Fed spokesman David Girardin declined to comment. New York Banking Department spokeswoman Glorimar Perez-Gonzalez told me, "We satisfied ourselves that the holding company structure is not being

used to evade U.S. taxes. We have no further comment on the matter." The IRS declined comment as well. The parent ICE holding company duly reported the Caymans company to the Securities and Exchange Commission, as required by law, in March 2009. The Securities and Exchange Commission (SEC) declined to discuss the matter. A spokesman merely told me that the agency does not approve or disapprove of the use of offshore structures; it just requires that owners disclose their existence.

This bifurcation of views and responsibilities is the problem, explains Adam Rosenzweig, associate professor of tax law and policy at the Washington University Law School in St. Louis. Rosenzweig, who specialized in Federal tax law relating to private equity, hedge funds, equity derivatives and cross-border capital markets before moving to academia, put it this way:

The SEC and Federal Reserve are treating ICE Trust U.S. as the place the action is going on. The tax law looks at ICE Trust U.S. and says all the action is happening at the holding company level in the Caymans. They are exploiting the benefit of being in the United States for regulatory purposes and being a foreign entity in the Caymans for tax purposes.

Some ICE Trust U.S. owner banks deny that they are currently using foreign subsidiaries to move money into the United States untaxed. Citigroup spokesperson Molly Meiners said, "The potential tax issue is not relevant to Citigroup. Citi deals with ICE Trust only through U.S. vehicles and pays all applicable taxes under U.S. code." Scott Silvestri, speaking for Bank of America and Merrill Lynch, said, "The ICE structure is not being used to bring profits back to the United States untaxed." J.P. Morgan's Justin G. Perras said, "JPM receives no beneficial tax treatment from its relationship with ICE Trust. Any implication otherwise is patently false." (The other U.S. owner banks, Goldman Sachs and Morgan Stanley, declined to comment.) However, the Caymans structure is difficult to fathom unless some of the owner banks want to move money to the exchange from foreign subsidiaries and dodge U.S. tax on those repatriated profits.

It is worth noting that many of these banks' subsidiaries are located in offshore locations where they pay no local taxes, so they would not benefit from treaties made to avoid double taxation; repatriated profits would be taxed in full. Goldman lists only 31 offshore subsidiaries in its SEC filing, though it acknowledges that it "aggregates" individual companies in its reporting. The subsidiaries include Amagansett Funding Ltd. in the Caymans and MLT investments in Mauritius. Morgan Stanley lists 321 offshore subsidiaries, including Morgan Stanley Berkshire Investments in Jersey and Morgan Stanley Morane Investments in Luxembourg. The other banks also have hundreds of offshore subsidiaries. Profits from these untaxed subsidiaries need to be invested, and the banks would prefer it to be done in ways that avoid taxation. Buying credit default swaps on ICE Trust U.S. allows the banks to do that.

Just how much money could skirt Section 956 via the ICE Caymans structure? Peter Vinella, managing director of the consulting firm LECG, says there is no way to know the number or value of trades being done through the U.S. banks' foreign subsidiaries because the figures aren't reported. "It's not transparent; there's no U.S.-owned market", said Vinella, who ran a global derivatives business as CEO of Wilmington Trust Conduit Services.

ICE Trust would not disclose the volume of margin payments it receives from foreign subsidiaries of U.S. banks. Vinella says margin requirements range from 5 percent of the contract for high-quality counterparties with standard structures to 15 percent for lower quality counterparties. Typical credit analyses, which include corporate family rating, financials, industry sector, country and news stories used to compute the probability of default, drive most judgments. "Most margins are around 7 percent, because most people do standard derivatives", he said.

"It's difficult to get real numbers on what is involved", agrees Michael Greenberger, former director of trading and markets at the Commodity Futures Trading Commission and current teacher at the University of Maryland School of Law. He asks, "What would be the amounts owed if tax obligations were triggered?

The whole market is deregulated or offshore. Reporting is very bad. That doesn't mean the IRS can't figure out amounts owed. But for a member of the public, trying to get information is very sketchy."

At the moment, ICE Trust U.S. is pretty small. During the nine months between March and December 2009, ICE Trust says it cleared more than \$3.1 trillion face value of North American credit default swap contracts and collected \$30 million in fees. But if Congress requires credit default swap trades to be conducted in a clearinghouse, the big banks that co-own ICE Trust U.S. have a ready-made vehicle to capture a share of what is expected to be a \$26-trillion market. Greenberger said the numbers then could eventually be quite significant: "If the taxes (on that margin) are going to be collected, the income stream to the IRS is going to be phenomenal. This would be well worth the IRS's time to get on top of."

University of Michigan Law School professor Reuven Avi-Yonah, who frequently testifies as an expert witness on tax issues in congressional hearings, said the ICE structure ought to be examined by the public, even if it is legal. "Not only do we have an entity in a tax haven, but it's also an entity with no substance, which is really a killer combination." A former corporate lawyer, Avi-Yonah told me, "I am not sure the IRS would reject it, but that doesn't mean it's okay; Congress should take a look."

Congress may do just that. Rep. Lloyd Doggett (D-TX), a long-time veteran of the fight against corporate tax evasion, had this to say about the ICE structure: "Too many multinational corporations obscure their tax avoidance activities through complicated offshore tax structures. Where the legitimate purpose is not clear, these structures deserve greater scrutiny." His office has passed on documentation about ICE to the Congressional Joint Committee on Taxation. Staff of the Senate Finance, Banking and Agriculture Committees, and the House Financial Services and Ways and Means Committees, as well as leading members of Congress who deal with derivatives and tax issues, were unaware of the ICE US Holding Company structure and declined to comment on the matter.

Nevertheless, the legislative wheels are grinding. Legislation passed by the House and Senate would require most or all traders for credit default swaps and other derivatives to use an exchange.

But another major reform—the “Volcker Rule” to ban banks trading on their own accounts—appears blocked. As this article goes to press, it is likely that a House-Senate conference committee will agree to sections in both bills to ban proprietary trades in derivatives by the big banks only if the financial regulators decide to do so. The “Volcker Rule”, proposed by former Federal Reserve Chair Paul Volcker and endorsed by President Obama, would have banned such trading. Under the House bill, the rules would be written jointly by the primary regulators of banks and bank holding companies—not likely to be tough on the banks. The House left it up to the regulators’ discretion, based on a particular company’s overall risk portfolio.

The Senate language is almost as ineffectual. The Senate’s bill tells the regulators to “study” limiting high-risk speculation by the big banks with their own capital in derivatives and other securities and would follow the regulators’ recommendations. But the decision would still be up to a council of “systemic risk” regulators, among

them the chairs of the Federal Reserve and Federal Deposit Insurance Corporation, the Treasury Secretary and the Comptroller of Currency.

An amendment filed by Senators Carl Levin and Merkley would make a proprietary trading ban law for banks that have Federal Deposit Insurance Corporation (FDIC) guarantees. Republicans prevented it from being considered. As I write, Levin and Merkley are still pressing for its adoption by the conferees.

Ironically, a staffer involved in the legislation said the final bill could be less effective than existing rules. They allow bank regulators to restrict proprietary trading if they think it is a threat to the safety and soundness of a particular banking institution, no “study” or high-level approvals required.

If the legislation passes without the Levin-Merkley ban on proprietary trading, ICE Trust U.S., with its Caymans parent company, is positioned to help the major American banks use their foreign profits to do U.S. credit default swap trades in a \$26-trillion market while dodging millions of dollars in taxation—a nifty double axel. Let’s hope Congress becomes aware of this scam and keeps U.S. taxpayers from getting iced by yet another banker’s “arrangement.” 🌐