CHAPTER 11.3

DERIVATIVES: BUSINESS CONDUCT AND MARKET INTEGRITY

CONTENTS

I. INTRODUCTION

In 2015, Federal Reserve Bank of New York President William Dudley remarked that,

> [t]wo years ago, I noted that recent scandals in banking evidenced 'deep-seated cultural and ethical failures.' Many of the industry's leaders now agree. According to the Federal Advisory Council of the Federal Reserve System, a group composed of senior representatives from the industry, "as often as not [...] the challenges faced in recent years have been behavioral and cultural; post-crisis episodes such as [London Interbank Offered Rates (LIBOR)] and foreign exchange manipulation provide hard evidence that there remains work to be done."

William Dudley, President, Fed. Rsrv. Bank of N.Y., Opening Remarks at Reforming Culture and Behavior in the Financial Services Industry: Workshop on Progress and Challenges (Nov. 5, 2015).

While ethics are undoubtedly the responsibility of individuals, ethical cultures and subcultures exist within a specific institutional context, and a key post-Financial Crisis insight is that the tone from the top is the responsibility of the board of directors and senior managers. Senior managers and employees make choices about their behaviors in part on the basis of their values, the contexts and organizational subcultures in which they operate, and the incentives they face. Long unregulated, at least not directly, there is now a focus on shaping ethical behavior by supervisory, regulatory, and enforcement measures.

In this Chapter, we first examine how the Dodd-Frank Act regulates the conduct of major players who trade derivatives and look at how the Dodd-Frank Act established the regulation of swap dealers and major swap participants. We also explore the business conduct requirements that the Dodd-Frank Act imposes on these institutions to enhance fairness and financial stability in the swaps market. While the securities and commodities markets have long regulated business conduct, the Dodd-Frank Act expanded the scope of these requirements by applying business conduct rules to the swaps market. *See, e.g.*, 17 C.F.R. § 240.10b-5 (2017); Commodity Exchange Act (CEA) § 9(a)(2). The rules follow a general theme: swap dealers (SDs), security-based swap dealers (SBSDs), major swap participants (MSPs), and major security-based swap participants (MSBSPs) must act fairly toward counterparties and customers. We also introduce the concept of position limits, which are designed to limit the ability of large market participants to manipulate prices.

We then turn to how regulators police business conduct standards and promote market integrity through enforcement actions. We explore the investigations of alleged abuses in the LIBOR and foreign exchange (FX) markets, which involved civil and criminal actions against firms and individuals. We also discuss reform of the reference rate market. We conclude by examining the extraterritorial application of U.S. rules as they apply to SDs and MSPs, and coordination with the European Union (EU). As G-20 reforms continue to be implemented around the world, U.S. regulators have increasingly emphasized deference to foreign jurisdictions with regard to cross-border transactions and the regulation of foreign subsidiaries of U.S. entities.

II. REGULATING THE KEY PARTICIPANTS

In this section, we focus on the regulation of key swap market participants through registration with the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) as SDs, SBSDs, MSPs, and MSBSPs, and the related applicable regulations. As discussed in Part IV, the CFTC and SEC have had, for many years, registration requirements and business conduct obligations for entities that act as futures commission merchants (FCMs) and broker-dealers. Before the Dodd-Frank Act, however, there was no similar registration requirement for key swap market participants. Title VII of the Dodd-Frank Act required these key market participants to register with the CFTC and SEC and to comply with new regulatory obligations. Although FX transactions are exempted from trading and clearing rules, the Dodd-Frank Act includes these transactions for business conduct purposes.

A. SWAP DEALERS AND SECURITY-BASED SWAP DEALERS

Dealers stand ready to purchase or sell a financial instrument at the request of their customers with the goal of buying or selling that instrument to or from other customers. In doing so, and in serving as a central point of contact for participants in the market, a dealer allows its client to buy or sell a financial instrument without looking for another end user who happens to want to take the opposite position. In many markets, including the securities and futures markets, dealers are subject to registration and heightened regulatory standards. These heightened regulatory standards are generally focused on (1) ensuring the safety and soundness of the dealers, (2) promoting efficient and safe markets, (3) protecting market participants who transact with dealers from unfair, improper, abusive, or fraudulent practices, (4) providing market transparency, and (5) reducing systemic risk.

The CEA and the Securities Exchange Act of 1934 (1934 Act), as amended by the Dodd-Frank Act, require the registration of dealers in the swap market as SDs, and dealers in the security-based swap market as SBSDs. An SD or SBSD is any entity that (1) holds itself out as a dealer in swaps or security-based swaps; (2) makes a market in swaps or security-based swaps; (3) regularly enters into swaps or security-based swaps with counterparties in the ordinary course of business; and (4) engages in any activity causing the entity to be commonly known in the trade as a dealer or market maker in swaps or security-based swaps. *See, e.g.*, CEA § 1a(49)(A), 7 U.S.C. § 1a(49)(A); *see also* 1934 Act § 3a(71)(A), 15 U.S.C. § 78c(a)(71)(A).

In recognition of the ambiguity of those terms, the CFTC and SEC jointly published rules that further define activities that would require an entity to register as an SD or SBSD:

- having a reputation in the market for being able to accommodate the demand and need for swaps and security-based swaps and providing advice to investors regarding swaps and security-based swaps;
- providing liquidity to the swap and security-based swap markets by matching buy and sell orders and seeking to profit from providing that liquidity to the market;

- acting as a market maker by quoting bid or offer prices for swaps and security-based swaps on an organized exchange or trading system;
- setting prices for swaps and security-based swaps offered in the market instead of accepting prices (although accepting prices does not foreclose a party from being categorized as a dealer); and
- holding itself out as a dealer by providing marketing materials to investors that describe the types of swaps and security-based swaps that the investor is interested in entering into.

See Alexandra Guest & Jack I. Habert, *Products and Registrants Under Title VII*, *in* OTC DERIVATIVES REGULATION UNDER DODD-FRANK: A GUIDE TO REGISTRATION, REPORTING, BUSINESS CONDUCT, AND CLEARING 23–32 (William C. Meehan & Gabriel D. Rosenberg eds., 2015).

As of June 2020, there were 109 provisionally registered SDs. Registered SDs include legal entities that are part of the largest global financial institutions, such as J.P. Morgan, Goldman Sachs, Bank of America, Morgan Stanley, Citigroup, and Credit Suisse. There are no registered SBSDs, as the SEC's rules do not require registration until November 2021.

The 1934 Act and the CEA, as amended by the Dodd-Frank Act, require an entity to register as an SD or SBSD only if it engages in more than a *de minimis* amount of swap dealing activity. In implementing this threshold, the CFTC set the *de minimis* amount for registration as an SD generally at:

- $8 billion in notional amount of swaps in a dealing capacity in the previous 12-month period; and
- $25 million in notional amount of swaps in a dealing capacity in the previous 12-month period with "special entities" (*e.g.*, federal and state agencies, cities, counties, municipalities, and certain employee benefit plans).

If a dealer exceeds either threshold, then it does not qualify for the *de minimis* exemption. CFTC Rule 1.3(ggg)(4), 17 C.F.R. § 1.3(ggg)(4); *see also* SEC Rule 240.3a71-2, 17 C.F.R. § 240.3a71-2 (similar requirements). For further details, see Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 77 Fed. Reg. 30,633 (May 23, 2012).

Not all swaps entered into by an entity, however, must be counted towards the *de minimis* threshold; market participants need not count swaps entered into to hedge their own commercial risks, swaps with 100% commonly owned affiliates, or certain swaps entered into by an insured depository institution in connection with loan activity. For example, a bank entering into interest rate swaps or FX swaps to hedge risks to its own balance sheet is not acting in a dealer capacity, and therefore would not need to count those hedges towards its *de minimis* threshold. In addition, there is a cross-border jurisdictional component to the *de minimis* calculation. Non-U.S. entities must look not only to the type of activity but also to the U.S.-person status of their counterparties to determine whether a particular swap must be counted towards the threshold. In 2018, the CFTC permanently adopted the $8 billion *de minimis* threshold. De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 56,666 (Nov. 13, 2018).

B. MAJOR SWAP PARTICIPANTS AND MAJOR SECURITY-BASED SWAP PARTICIPANTS

In addition to requiring registration of dealers in the swaps market, Title VII requires the registration and regulation of market participants that are not dealers but are large enough to pose risks to the marketplace. This concept—not found in broker-dealer or futures regulation—was inspired by the experience of AIG Financial Products during the Financial Crisis, as well as earlier experiences, such as the rise and collapse of Enron. Title VII requires major non-dealer market participants to register as MSPs (for swaps) and MSBSPs (for security-based swaps).

An MSP or MSBSP is any entity that is not an SD or SBSD and that (1) maintains a substantial position in swaps or security-based swaps; (2) holds swaps or security-based swaps that create substantial counterparty exposure that could seriously affect the stability of the U.S. banking system or financial markets; or (3) is a highly leveraged financial entity not subject to capital requirements established by a federal banking agency and that maintains a substantial position in swaps or security-based swaps. CEA § 1a(33), 7 U.S.C. § 1a(33); 1934 Act § 3(a)(67), 15 U.S.C. § 78c(a)(67).

The CFTC and SEC have implemented this relatively open standard through a set of quantitative tests that look to (1) the amount an entity currently owes to its counterparties on swaps; and (2) a calculation of potential future exposure that serves as a proxy for how much an entity may owe in the future on its swaps. Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," and "Eligible Contract Participant," 77 Fed. Reg. 30,751–53 (May 23, 2012). These thresholds are set high enough that as of September 2020, no entities are registered as MSPs. Nat'l Futures Ass'n., *Membership and Directories*. No MSBSPs are registered and the SEC's rules do not require MSBSPs registration until December 2021; the SEC estimates that between zero and five would need to register. Registration Process for Security-Based Swap Dealers and Major Security-Based Swap Participants, 80 Fed. Reg. 48,964, 49,000 (Aug. 14, 2015).

C. REGULATORY OBLIGATIONS OF KEY MARKET PARTICIPANTS

Registration as an SD, SBSD, MSP, or MSBSP comes with significant regulatory obligations. Before the Dodd-Frank Act, over-the-counter (OTC) derivatives dealers were, in effect, self-regulating with respect to swap and security-based swap activity. For example, dealers determined appropriate risk management for swap activity and put into place their own bespoke swap documentation agreements with counterparties, which included limited counterparty representations and due diligence procedures. No public body of law, however, regulated these activities. During the Financial Crisis, it became clear that this self-regulation had substantial shortcomings. Swap counterparties were unable to make informed decisions before entering into these transactions due to the lack of transparency and the complexity of the documentation. For example, the SEC alleged that a dealer charged Jefferson County, Alabama higher rates than sophisticated market participants in connection with municipal securities underwriting and interest swap agreements because county officials were less

informed than other market participants. *See* In the Matter of J.P. Morgan Securities Inc., Exchange Act Release No. 60,928 (Nov. 4, 2009).

To resolve these issues, Title VII of the Dodd-Frank Act requires SDs, SBSDs, MSPs, and MSBSPs to comply with business conduct standards that require fair dealing and trade disclosures, written trading documentation and swap confirmations that contain all applicable terms of a swap transaction, and portfolio reconciliation to confirm that the terms of their swaps match the terms in the records of their counterparties. These entities are also subject to enhanced capital requirements, robust risk management program requirements, and significant new compliance and regulatory reporting obligations.

1. Fair Dealing

In an attempt to provide swaps customers with the full picture of the risks of entering into these transactions, Congress imposed new business conduct standards on SDs, SBSDs, MSPs, and MSBSPs. The CFTC's external business conduct rules fall into three general categories:

- **Verification of Counterparty Eligibility.** SDs and MSPs must obtain information sufficient to ascertain whether their counterparties are considered sophisticated enough to be permitted to enter into swaps (known as eligible contract participants) or whether they are special entities. They must also obtain know-your-counterparty information, including their counterparty's name, address, and clearing status.
- **Disclosure Requirements.** SDs and MSPs must disclose key information to the counterparties to the trade. In particular, SDs and MSPs must disclose to end-user counterparties the material characteristics and risks of the swap and any conflicts of interest the SD may have. In addition, they must inform counterparties that they have the right to receive a scenario analysis, which is a description of how the swap is expected to perform in various market conditions, and the right to have their swaps cleared by a derivatives clearing organization of their choosing.
- **Suitability and Other Sales Practice Standards.** When recommending a swap, an SD or MSP must ensure that the swap is suitable for its prospective counterparty. SDs and MSPs must communicate with counterparties in a "fair and balanced manner based on principles of fair dealing and good faith." SDs and MSPs are subject to specific anti-fraud and anti-manipulation provisions, as well as restrictions on the use of material confidential counterparty information adverse to their counterparty.

See 17 C.F.R. §§ 23.430–34 (2017).

As mentioned above, SDs have heightened regulatory obligations when advising or dealing with special entities. The SEC has also implemented business conduct rules for SBSDs that are analogous to the CFTC's rules for SDs. Business Conduct Standards for Security-Based Swap Dealers and Major Security-Based Swap Participants, 81 Fed. Reg. 29,960 (May 13, 2016). These heightened duties are a direct result of the significant losses incurred by government agencies, municipalities, charitable institution endowments, and beneficiaries of pension

and retirement funds during the Financial Crisis because of derivatives exposures. Congress cited to the fact that many financial institutions encouraged governmental entities and retirement and pension plans to enter into sophisticated swap transactions that they knew or should have known were inappropriate or unsuitable for these clients. *Wall Street Reform and Consumer Protection Act—Conference Report*, 111th Cong. 5923 (2010) (statement of Sen. Blanche Lincoln). The heightened rules for transacting with special entities are indicative of Congress's increased awareness that special entities "play an important public interest role by virtue of their responsibility for managing taxpayer funds, the assets of public and private employee pension plans and endowments of charitable institutions." Business Conduct Standards for Swap Dealers and Major Swap Participants with Counterparties, 77 Fed. Reg. 9,817 (Feb. 17, 2012).

2. Swap Trading Relationship Documentation and Confirmations

SDs and MSPs must execute written trading documentation with counterparties. The documentation must include all terms governing the trading relationship between the SD and the counterparty. The regulations require the exchange of information between SDs or MSPs and their counterparties through acknowledgments and written confirmations of each swap, which together with the trading documentation memorialize the agreement of the counterparties to all terms of each swap. SDs and MSPs must provide their counterparties with that confirmation "as soon as technologically possible," with certain exceptions.

3. Portfolio Reconciliation and Dispute Resolution

SDs and MSPs must also perform periodic "portfolio reconciliation" and establish dispute resolution procedures with swap counterparties. Portfolio reconciliation is a post-trade execution process and a risk management tool that is designed to: (1) identify and resolve any discrepancies between the records of the counterparties regarding the terms of a swap and the valuation of the swap; and (2) ensure effective confirmation of all terms of the swap. The frequency with which parties must engage in portfolio reconciliation ranges from daily to annually and depends on the number of swaps in the counterparties' portfolio and the parties involved (*e.g.*, whether one party is an end user).

4. Capital Requirements

The CEA, as amended by the Dodd-Frank Act, requires the CFTC to adopt minimum capital requirements for SDs and MSPs that are not prudentially regulated (*e.g.*, an SD that is not a bank). For SDs and MSPs that are prudentially regulated, the Treasury, Federal Reserve, OCC, FDIC, the Farm Credit Administration, and Federal Housing Finance Agency (prudential regulators) published a joint final rule regarding capital and margin requirements. Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74,840 (Nov. 30, 2015). In July 2020, the CFTC finalized its capital rules for SDs and MSPs, which are based, in part, on concepts set forth under the Basel capital requirements, which we discussed in Chapters 2.5, 2.6 and 2.7. The capital requirements under the final rule set forth the minimum levels of capital that SDs

and MSPs are required to maintain, which differs based on whether the SD or MSP is also registered as an FCM, whether the SD is a nonbank subsidiary of a U.S. bank holding company (BHC), or whether the SD is "predominantly engaged in non-financial activities." The rule also requires MSPs to maintain a positive tangible net worth. Capital Requirements of Swap Dealers and Major Swap Participants, 85 Fed. Reg. 57,462 (Sept. 15. 2020). The SEC has also issued its final rule. Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 17 C.F.R. §§ 200, 240.

5. Risk Management, Portfolio Compression, and Conflicts Rules

Before the Dodd-Frank Act, financial institutions were not required to have robust risk management practices specifically related to their derivatives businesses. In fact, some have attributed the failure of AIG Financial Products to poor risk management of derivatives products. Some have alleged that AIG Financial Products was able to engage in highly risky behavior without significant oversight because its derivatives activities were unregulated, ultimately leading to the company's near-collapse, averted only by government bailouts. *See* FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 139–42 (2011).

Congress sought to correct this deficiency by requiring each SD and MSP to establish, document, maintain, and enforce a risk management program designed to monitor and manage the risks associated with its swap activities. Reflecting an integrated approach to risk management at the consolidated entity level, the CFTC's regulation requires an SD or MSP to take into account its own risks and those of its affiliates. The risk management program must monitor risks associated with the entity's swap activities and establish risk tolerance limits. Additionally, the internal business conduct rules require that SDs and MSPs prepare for adverse economic scenarios. Specifically, they must implement a "business continuity and disaster recovery plan," which requires the entity to outline procedures for dealing with a major disruption in business activities. Through this plan, SDs and MSPs must outline mechanisms for (1) resuming operations by the next business day with little disturbance to counterparties and the market; and (2) recovering all required records.

Additionally, SDs must engage in portfolio compression exercises with their swap counterparties, which, like portfolio reconciliation, is a post-trade execution process. Portfolio compression generally involves the swap counterparties terminating or adjusting the notional value of some or all of the swaps between them and replacing those swaps with other swaps that have a lesser combined notional value. The complicated portfolio compression process is designed to reduce the overall notional size and number of swaps between the counterparties without changing the overall swap risk profile or value of the swap portfolio. Portfolio compression is widely used by market participants and effectively allows parties to engage in netting, a concept discussed in Chapter 11.2 with respect to clearing. At its most basic, compression allows SDs to simplify the management of large swap portfolios by aggregating swap positions into fewer overall contracts with reduced outstanding notional values.

SDs and MSPs must also take steps to minimize conflicts of interest by creating firewalls between certain departments within the entity. For example, the trading department cannot interfere with the research department's reports.

6. Risk Exposure and Chief Compliance Officer Reports

SDs must submit quarterly risk exposure reports to their senior management, the SD's board of directors, and the CFTC. These reports include an overview of the SD risk profile and information relating to risk management program implementation and any recommended changes. The SD's chief compliance officer must also prepare and submit an annual compliance report and certification to the SD's board of directors or senior officer and to the CFTC. The report must contain a review of each requirement under the CEA and CFTC regulations that applies to the SD, an assessment regarding the effectiveness of the SD's policies and procedures for each of those requirements, and any necessary or recommended changes to the firm's policies and procedures or compliance program as a result of the chief compliance officer's annual review.

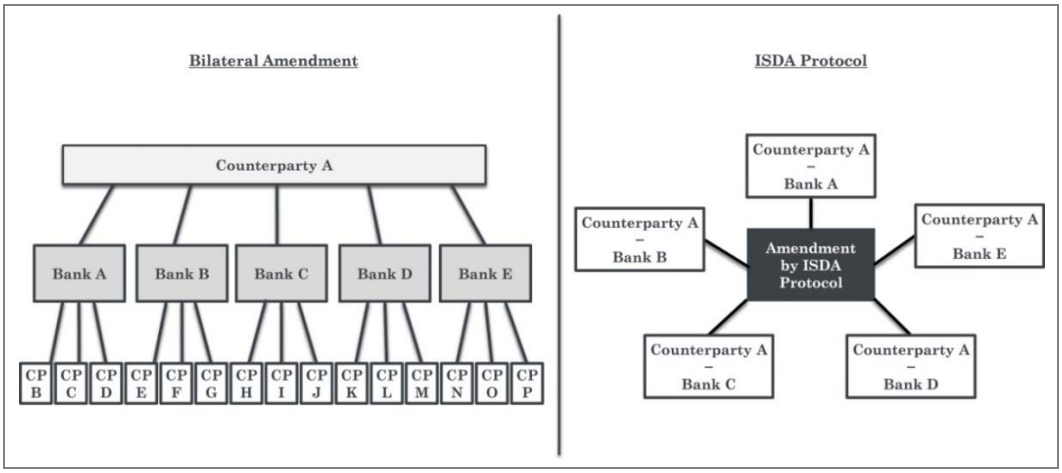
D. POST-DODD-FRANK ACT ISDA PROTOCOLS

Before the Dodd-Frank Act, many counterparties had documentation in place to trade swaps. As you have learned, most used a standard agreement created by the International Swaps and Derivatives Association (ISDA), known as the ISDA Master Agreement. A large bank may have had thousands of ISDA Master Agreements in place with its various counterparties. The new rules adopted by the CFTC under Title VII required changes to this existing documentation. For example, since the external business conduct rules require that certain representations be made before swaps are entered into, the rule effectively requires amended documentation. Given the large numbers of ISDA Master Agreements, however, it would have been impractical for every pair of counterparties to individually negotiate and amend existing documentation as needed to comply with the new requirements.

To solve this problem, ISDA developed two protocols that provided a centralized method for SDs to amend their ISDA Master Agreements. A protocol is a multilateral contractual mechanism that allows for standardized amendments to be made to swap agreements between all adhering parties, rather than requiring every pair of counterparties to negotiate. Put another way, the protocols allowed counterparties to agree once to be bound by the terms of each protocol and, through a web-based platform, to notify counterparties of that agreement. If both counterparties matched terms, the existing trading documentation between them would automatically be amended to include the revised provisions. The protocols, thus, provide a simplified way for swap market participants to amend existing documentation without engaging in tedious and numerous bilateral negotiations.

ISDA has developed two primary Dodd-Frank Act business conduct protocols: the August 2012 DF Protocol, which relates to compliance with the CFTC's external business conduct rules, and the March 2013 DF Protocol, which addresses the CFTC's rules on (1) swap trading documentation, (2) the end-user exception to the clearing requirement, and (3) portfolio reconciliation. As of August 2020, each of these protocols had around 25,000 adhering parties.

Figure 11.3-1 Diagram of ISDA Protocol Multilateral Amendment Process



E. POSITION LIMITS

Like other market participants, SDs and MSPs are subject to position limits in swaps. The CEA allows the CFTC to set position limits on commodity derivatives as "necessary to diminish, eliminate, or prevent" excessive speculation. 7 U.S.C. § 6a(a)(1). The Dodd-Frank Act amended the CEA to require the CFTC to "establish limits on the amount of positions...that may be held by any person with respect to [commodity derivative] contracts." Dodd-Frank Act § 737. The Dodd-Frank amendment, however, was unclear as to whether the CFTC needed to make a necessity determination before issuing position limits. Market participants argued that, before the Dodd-Frank Act, the CFTC would have had to show that position limits curb excessive speculation before issuing such restraints. Conversely, the CFTC argued that Congress intended the new CEA language to require the CFTC to enact position limits irrespective of any such determination.

In 2011, the CFTC adopted position limit rules without a necessity finding. The position limits restricted the number of contracts a market participant could hold in swaps, futures, and options based on 28 physical commodities. Position Limits for Derivatives, 76 Fed. Reg. 4,752 (Jan. 26, 2011). ISDA and the Securities Industry and Financial Markets Association sued, arguing that the Dodd-Frank Act did not do away with the necessity requirement. *Int'l Swaps & Derivatives Ass'n v. Commodity Futures Trading Comm'n*, 887 F. Supp. 2d 259 (D.D.C. 2012). The district court noted the CFTC's position in its Final Rule: "Congress did not give the Commission a choice. Congress directed the Commission to impose position limits and to do so expeditiously." 76 Fed. Reg. at 71,628. The district court vacated the CFTC's rule on *Chevron* grounds, holding that "deference to an agency's interpretation of a statute is not appropriate when the agency wrongly believes that interpretation is compelled by Congress." 887 F. Supp. 2d at 280–81 (internal quotations and citation omitted).

The CFTC re-proposed position limits in 2013. Position Limits for Derivatives, 78 Fed. Reg. 75,680 (Dec. 12, 2013). The proposal effectively reinstated the vacated rule but, to comply with the District Court's finding, the CFTC made a necessity determination to avoid future litigation. The CFTC concluded that position limits reduce speculation. In October 2020, the CFTC finalized position limits for 25

physical commodities, on a divided vote. The rule exempts a wider range of hedging practices from position limits, permits market participants to self-designate hedging as exempt under certain circumstances, simplifies the process for requesting an exemption, and includes necessity determinations. CFTC, RIN 3038-AD99, VOTING DRAFT: POSITION LIMITS FOR DERIVATIVES (2020).

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1. ***Business Conduct Rules.*** If you were writing the business conduct rules, what types of SD activities would you attempt to regulate? Recall our discussion of disclosure in Chapter 5.4. Do you think that disclosure would be helpful in reducing the likelihood that a counterparty would enter into an excessively risky swap transaction? If not, what do you think might prevent a counterparty from entering into a swap transaction that might not be suitable to that counterparty? Should disclosure and sales practice standards vary by the counterparty, as in the Dodd-Frank Act, or should there be a uniform rule across the market?

2. ***MSP and MSBSP Standards.*** How would you have determined which entities meet the MSP and MSBSP standard in order to capture non-dealer entities like AIG Financial Products? Would you have adopted a prescriptive approach, like the CFTC and SEC, to identify these market participants? *See* Jai Massari & Gabriel Rosenberg, *The Perils of a Middle Road to Regulating Systemic Risk: The Volcker Rule's Risk Backstop Provisions*, 104 GEO. L.J. 145 (2015).

III. MARKET INTEGRITY

After the Financial Crisis, enforcement agencies in many different jurisdictions undertook investigations into manipulation in LIBOR rate-setting and in the FX markets. These investigations were broad in scope, involved multiple financial institutions operating in several different jurisdictions, and resulted in billions of dollars in fines. Recall our discussion of market manipulation in Chapter 4.3, involving the submission of false bids for government securities by an individual at Salomon Brothers. In this case, the agencies alleged that traders used a number of similar techniques to manipulate LIBOR and FX rates. Separate from their LIBOR and FX investigations, the CFTC and SEC have also enforced their regulations under Title VII of the Dodd-Frank Act. We discuss the CFTC's and SEC's Title VII enforcement actions at the end of this section.

A. LONDON INTERBANK OFFERED RATE MANIPULATION

1. Background

What connects syndicated corporate loans, private college loans, and adjustable rate mortgages to the massive and complex derivatives market? The London Interbank Offered Rate, known as LIBOR. This is the prime example of a benchmark interest rate—a rate used as the basis of derivatives and contract interest rates worldwide. LIBOR is intended to reflect interbank lending in the London money markets, in which financial institutions engage in borrowing and lending money for maturities of up to one year. LIBOR is calculated by taking a

trimmed mean average of inputs from the major financial institutions operating in the London money markets. These inputs reflect the subjective rate at which an institution reports it could borrow money at different maturities. LIBOR is used as a reference point for derivatives and other contracts. In 2012, for instance, LIBOR was referenced in derivatives and other transactions worth $360 trillion. Dennis Kuo et al., Fed. Rsrv. Bank of N.Y., A Comparison of LIBOR to Other Measures of Bank Borrowing Costs 1 (2012) (unpublished manuscript).

Although the most important, LIBOR is not the only benchmark interest rate. There are similar rates in different markets extending from Europe (EURIBOR) to Japan (Euroyen TIBOR), and even more obscure rates in markets like Mauritius (the Port Louis Interbank Offered Rate, or PLIBOR). Other reference rates are based on averages of swap rates, such as the ISDAFix.

The methodology for setting LIBOR developed in the 1980s, when the OTC derivatives market was in its infancy and the impact of the rate was confined. The British Bankers' Association (BBA) established the rate for the benefit of its members. Having a benchmark reference rate is beneficial to developing a market in which standardization of contracts plays an important role. The utility of LIBOR is underscored by its prevalence and significance. As you have seen, by the time of the Financial Crisis, the derivatives market had expanded to proportions that were inconceivable in the 1980s. The LIBOR rate, a key part of the market infrastructure was, however, still determined by essentially the same methodology, and there was no impetus for change.

At the time of the Financial Crisis, LIBOR had several significant structural problems that could lead to its manipulation. First, submitted rates were non-binding, banks were not required to prove the accuracy of their quotes, and the quotes submitted did not have to reflect real transactions. François-Louis Michaud & Christian Upper, *What Drives Interbank Rates? Evidence from the LIBOR Panel*, BIS Q. REV., Mar. 2008, at 47, 48. No safeguards existed to prevent a bank from submitting inaccurate rates. Second, because the BBA represented the contributor banks, conflicts of interest existed. HER MAJESTY'S TREASURY, THE WHEATLEY REVIEW OF LIBOR: FINAL REPORT 21 (Sept. 2012) [WHEATLEY REVIEW]. Finally, the contributor banks' submissions were made public after the rate was determined. How do you think the knowledge of other banks' recently submitted lending rates could affect LIBOR-submitter behavior?

2. LIBOR Misconduct

On June 27, 2012, Barclays resolved several regulatory and governmental investigations involving misconduct related to LIBOR. Barclays entered into a non-prosecution agreement with the DOJ, which fined the bank $160 million, a settlement with the CFTC, which fined the bank $200 million and required Barclays to agree to various undertakings, and a fine of £59.5 million discounted from £85 million for early settlement from the UK financial services regulator, then the Financial Services Authority (FSA), now the Financial Conduct Authority (FCA). The fines were at that time the largest in the history of the CFTC and FSA. The CFTC and DOJ alleged misconduct relating to Barclays's LIBOR and EURIBOR submissions, including:

- derivatives traders inside the bank requesting that the bank's LIBOR submitters make particular submissions in order to benefit their trading positions;
- requests made to Barclays's submitters by traders outside the bank, including traders who had previously worked at Barclays;
- requests made by Barclays's derivatives traders to LIBOR submitters at other banks; and
- senior management instructions to reduce Barclays's LIBOR submissions owing to negative media and market perceptions that Barclays had a liquidity problem based, in part, on its high LIBOR submissions.

The settlement caused a major market impact—Barclays's share price slid 18% in value the day the settlement was announced—and a strong media response. The settlement also resulted in high-profile resignations (including by Barclays's Chair, its CEO, and his deputy), hearings in the UK Parliament, the establishment of the UK Parliamentary Commission on Banking Standards, a full-scale review of the LIBOR submission process, and the introduction of new criminal offenses of LIBOR manipulation by UK legislators. The FSA alleged misconduct based in part on communications between traders. For example, the FSA identified the following problematic communications:

- On Monday, 13 March 2006, the following email exchange took place:

  Trader C: "The big day [has] arrived.... My NYK are screaming at me about an unchanged 3m libor. As always, any help wd be greatly appreciated. What do you think you'll go for 3m?"

  Submitter: "I am going 90 altho 91 is what I should be posting"

  Trader C: "...when I retire and write a book about this business your name will be written in golden letters...."

  Submitter: "I would prefer this not be in any book!"

- Trader C requested low one month and three month US dollar LIBOR submissions at 10:52 am on 7 April 2006 (shortly before the submissions were due to be made); "If it's not too late low 1m and 3m would be nice, but please feel free to say 'no'.... Coffees will be coming your way either way, just to say thank you for your help in the past few weeks." A Submitter responded "Done...for you big boy."
- On 26 October 2006, an external trader made a request for a lower three month US dollar LIBOR submission. The external trader stated in an email to Trader G at Barclays "If it comes in unchanged I'm a dead man." Trader G responded that he would "have a chat." Barclays's submission on that day for three month US dollar LIBOR was half a basis point lower than the day before, rather than being unchanged. The external trader thanked Trader G for Barclays's LIBOR submission later that day: "Dude. I owe you big time! Come over one day after work and I'm opening a bottle of Bollinger."
- On 28 February 2007, Trader B made a request to an external trader in relation to three month US dollar LIBOR "duuuude...whats up with ur

> guys 34.5 3m fix...tell him to get it up!!" The external trader responded "ill talk to him right away."
>
> - On 5 February 2008, Trader B (a U.S. dollar Derivatives Trader) stated in a telephone conversation with Manager B that Barclays's Submitter was submitting "the highest LIBOR of anybody.... He's like, I think this is where it should be. I'm like, dude, you're killing us." Manager B instructed Trader B to: "just tell him to keep it, to put it low." Trader B said that he had "begged" the Submitter to put in a low LIBOR submission and the Submitter had said he would "see what I can do."

FSA FINAL NOTICE TO BARCLAYS BANK PLC ¶¶ 57, 59, 65, 83, 91 (June 27, 2012).

The settlements raised questions about the extent of the misconduct and other firms' involvement. There were allegations that others in the financial sector knew of the misconduct:

> [A] senior Barclays Treasury manager informed BBA in a telephone call that it had not been reporting accurately, although he noted that Barclays was not the worst offender of the panel bank members. "We're clean, but we're dirty-clean, rather than clean-clean." The BBA representative responded, "no one's clean-clean."

CFTC, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, As Amended, Making Findings and Imposing Remedial Sanctions 23 (June 27, 2012).

The coordinated settlement was an example of increased international cooperation on enforcement regarding alleged manipulation or attempted manipulation in a wide variety of rates and derivatives tied to rates. The Barclays settlement was followed by settlements with other banks and broker-dealers, including UBS, Royal Bank of Scotland, Rabobank, Deutsche Bank, Lloyds, Société Générale, J.P. Morgan, Citigroup, ICAP, and a range of others. These settlements involved multiple authorities: the CFTC, DOJ, UK FSA/FCA, European Commission, Japan Financial Services Agency, Swiss Financial Market Supervisory Authority, and the Dutch Prosecution Service, to name a few. The actions resulted in the imposition of billions of dollars in fines, with the largest fine, approximately $2.5 billion, imposed on Deutsche Bank.

Authorities are also pursuing individuals in criminal prosecutions and regulatory actions. Convictions have been sought on both sides of the Atlantic. In 2016, a former UBS trader was sentenced to 14 years in prison in the UK after being found guilty of eight charges of conspiracy to defraud. Other convictions, but also acquittals, followed. In the United States, the DOJ is prosecuting a number of individuals, and three have pleaded guilty. Press Release, Dep't of Justice, Deutsche Bank's London Subsidiary Agrees to Plead Guilty in Connection with Long-Running Manipulation of LIBOR (Apr. 23, 2015). The convictions of two former Rabobank employees were, however, overturned by the Second Circuit in July 2017, on the basis that evidence compelled by the UK FCA and disclosed to a key witness for the U.S. prosecution (in accordance with regular UK procedure requiring disclosure of relevant documents to investigation subjects) tainted the U.S. government's case, constituting a violation of the defendants' Fifth Amendment privilege against self-incrimination. *United States v. Allen*, 864 F.3d

63 (2d Cir. 2017). In this "brave new world of international criminal enforcement," as Judge Cabranes put it, *id.* at 90, it remains to be seen whether the close cooperation between U.S. and UK authorities will continue.

3. Reform

LIBOR affects trillions of dollars in derivatives and transactions used across the world, and legislators and regulators responded with calls for structural reform. WHEATLEY REVIEW, at 3. In 2012, the UK's Chancellor of the Exchequer commissioned the Wheatley Review to examine and propose changes to LIBOR's framework. Based on the Wheatley Review's recommendations, the UK enacted reforms with the goal of restoring public confidence in LIBOR. *See* FSA, THE REG. & SUPERVISION OF BENCHMARKS (2013). Contributor banks were required to ensure submissions are based on objective criteria and relevant information and establish procedures to manage conflicts of interest arising from LIBOR submissions. If a bank suspects any person is manipulating LIBOR, it must report the conduct to government authorities. Contributor banks received annual audits concerning their LIBOR submission process. The UK and the BBA also agreed to transfer the administration of LIBOR to Intercontinental Exchange in 2014. Philip Stafford, *Intercontinental Exchange to Take Over Running Libor Benchmark*, FIN. TIMES (Jan. 17, 2014). Intercontinental Exchange is a U.S. public company that operates exchanges and clearinghouses, including the New York Stock Exchange. Reacting to the governance problems associated with the BBA operating LIBOR, regulators believed than an independent LIBOR administrator would ensure "strong and credible governance." WHEATLEY REVIEW, at 21.

This proved to be a short-lived approach. The UK FCA announced in July 2017 that LIBOR will end in 2021, allowing for a transition period during which market participants will transition to alternative reference rates. The markets underlying LIBOR had become markedly less liquid than they used to be. Andrew Bailey, Chief Exec., Fin. Conduct Auth., Speech at the Securities Industry and Financial Market Association's LIBOR Transition Briefing in New York, USA: LIBOR: Preparing for the End (July 15, 2019).

Commentators had for years debated how to replace LIBOR. *See, e.g.*, Michael S. Barr, *Too LIBOR, Too Late: Time to Move to a Market Rate*, 2 COMPETITION POL'Y INT'L ANTITRUST CHRON. 11 (2012) (arguing for the use of market rates). *See also* Darrell Duffie & Piotr Dworczak, *Robust Benchmark Design* (Stan. U. Graduate Sch. of Bus., Working Paper No. 3175) (Mar. 2018). One option considered was to use the overnight-indexed swap rate as a benchmark instead of LIBOR. The overnight-indexed swap rate relies on real transactions, which means the rate is less susceptible to false submissions compared to LIBOR. The Wheatley Review suggested, however, that the overnight-indexed swap rate is insufficiently liquid to create a reliable benchmark rate. Repurchase, or repo, rates could also serve as a substitute for LIBOR. There are multiple published and widely followed repo rates in the market. Repo rates are influenced by the liquidity and credit risk of the underlying collateral, and they reflect factors that the unsecured LIBOR rate excludes. Because the rate reflects the market's view of *both* collateral and the borrower's creditworthiness, commentators suggested, however, that it may also be an ineffective benchmark rate. *See* WHEATLEY REVIEW, at 50.

In the UK, the Bank of England established a working group to identify an alternative reference rate that was closer to a risk-free rate. The working group has selected SONIA (Sterling Overnight Index Average) as its proposed alternative benchmark. SONIA underwent a series of reforms in 2018 as part of the Bank of England's efforts to strengthen the benchmark. The reformed benchmark includes a wider scope of transactions, reflecting more than a threefold increase of the underlying transaction volume. News Release, Bank of England, SONIA Reform Implemented (Apr. 23, 2018). The Bank of England began publishing the SONIA Compounded Index in August 2020 to support the transition away from LIBOR. Additionally, the working group has published materials to assist market participants and has outlined a roadmap of its top level priorities, including establishing a framework to manage the transition of legacy LIBOR contracts. *See UK Working Group on Sterling Risk-Free Reference Rates (RFR WG) 2020–21 Top Level Priorities*, BANK OF ENGLAND (July 2020).

The U.S. Alternative Reference Rates Committee (ARRC), a public-private working group set up by the Federal Reserve at the recommendation of the FSOC, has identified SOFR (Secured Overnight Financing Rate), a rate based on overnight repurchase transactions collateralized by Treasuries, as its preferred alternative. The ARRC has recommended best practices regarding transition milestones for market participants and developed a Paced Transition Plan, setting out a timeline and steps to support the adoption of SOFR. As part of the plan, in 2018, the Federal Reserve Bank of New York began publishing SOFR; CME and ICE launched SOFR futures contracts; and clearinghouses began clearing SOFR swaps. *LIBOR Transition Timeline*, PAUL HASTINGS (July 24, 2020). In April 2020, the ARRC announced its key objectives for 2020, including supporting SOFR use and liquidity, strengthening market infrastructure, publishing contractual fallbacks, supporting consumer education and outreach, increasing clarity on legal, tax, accounting, and regulatory matters, and advancing global coordination. *See 2020 Objectives*, ALT. REFERENCE RATES COMM., (Apr. 17, 2020). The CFTC has also issued no-action letters providing relief to market participants in connection with the transition and the U.S. prudential regulators have clarified the treatment of transition-related amendments under their uncleared margin rules.

The most frequently used tenors of U.S. dollar LIBOR were supposed to cease publication at the end of 2021, but this date has been extended to June 30, 2023. The UK Treasury announced that it intends to enact legislation granting the FCA extended powers to manage the transition. Edwin Schooling Latter, *LIBOR Transition – The Critical Tasks Ahead of Us in the Second Half of 2020*, FIN. CONDUCT. AUTH. (Aug. 3, 2020). The ISDA Fallback Protocol will allow existing derivatives contracts currently referencing LIBOR to transition to reference rates based on the alternative reference rates adopted in the relevant jurisdictions. *ISDA Board Statement on Adherence to the IBOR Fallback Protocol*, ISDA (July 29, 2020).

The EU has also undertaken steps to smoothen the transition. The European Commission proposed amendments to the EU Benchmarks Regulation (BMR) in support of the transition. *See Commission's Proposal to Amend EU Rules on Financial Benchmarks*, EUR. COMM. (July 24, 2020). BMR initially came into effect in 2018 as a response to the LIBOR scandals. *The New EU Benchmarks*

Regulation: What You Need to Know, CLIFFORD CHANCE (Sept. 2016). The Commission proposes it be granted the power to designate a replacement benchmark for legacy LIBOR contracts. In selecting the benchmark, it would take into account recommendations by industry working groups. The proposal is intended to facilitate the orderly wind down of legacy contracts and avoid significant disruptions to EU markets. Proposal for a Regulation of the European Parliament and of the Council Amending Regulation (EU) 2016/1011, COM(2020) 337 final (July 24, 2020).

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1. ***Alternative Reference Rates.*** What do you make of the approaches from the United States and the UK regarding a replacement for LIBOR? What are the advantages and disadvantages of each? Is a multi-rate approach preferable to a single replacement rate? How will the market transition to these new benchmarks? Should policy-makers regulate benchmarks and other indices that could be systemically important? *See* Robert C. Hockett and Saule T. Omarova, *Systemically Significant Prices*, 2 J. FIN. REG. 1 (2016); *See also* Megan Shearer, Gabriel Rauterberg & Michael P. Wellman, *An Agent-Based Model of Financial Benchmark Manipulation*, ICML-19 Workshop on AI in Finance (2019) (analyzing effects of benchmark manipulation on market microstructure).

2. ***CFTC Undertakings.*** The banks and broker-dealers fined by the CFTC agreed to comply with a lengthy list of undertakings as part of their settlements. The banks agreed to apply specified factors in determining LIBOR submissions; implement internal controls to prevent conflicts of interest arising between submitters and derivatives traders; document the rationale for their submissions; retain related transactional information and communications data; engage in monitoring and auditing; establish policies, procedures, and controls; conduct training; and make reports to the CFTC on compliance with the undertakings. Is this regulation by the back door of enforcement? To what extent do you consider it appropriate for these terms to be determined through bilateral settlements?

B. FOREIGN EXCHANGE RATE-RIGGING

1. Background

The FX market is a largely OTC market where traders buy, sell, exchange, hedge, and speculate on currencies. *See generally* MARC LEVINSON, GUIDE TO FINANCIAL MARKETS: WHY THEY EXIST AND HOW THEY WORK 15–23 (2006). The FX market is the largest and most liquid financial market in the world with an average daily turnover of $5.3 trillion. Fed. Rsrv. Bank of N.Y., *Managing Foreign Exchange Risk*; *see also* Dagfin Rime & Andreas Schrimpf, *The Anatomy of the Global FX Market Through the Lens of the 2013 Triennial Survey*, BIS Q. REV., Dec. 2013, at 27. Until recently, it has been largely unregulated.

Although the FX market is decentralized, services have emerged to help standardize rates. For example, the WM/Reuters service created benchmark rates in FX. The service produces several rates in a day, but the "WM/R 4 p.m. London

fix" is perhaps the most influential. WM/Reuters calculates the 4 p.m. fix by extracting actual FX trades occurring during the fix period (3:59:30 p.m. to 4:00:30 p.m. in London) from an electronic trading system. The benchmark rates are the median prices for each currency pair. *In re* J.P. Morgan Chase Bank, CFTC Docket No. 15–04, 4 (Nov. 11, 2014).

In 2014, Citigroup, Deutsche Bank, Barclays, UBS, and HSBC accounted, on a combined basis, for more than 60% of FX trading. *Citi Reclaims Top Ranking in Benchmark Euromoney Foreign Exchange Survey*, REUTERS (May 9, 2014). Markets with so few participants may be more susceptible to collusive activity. Because the FX market is decentralized, information is fragmented and opaque, making it difficult for market participants to monitor and compare bid and ask offers. *See* Rime & Schrimpf, at 27.

2. Alleged Manipulation

The scope of the alleged manipulation in the FX markets was made public through coordinated settlements. Rather than taking action against firms one by one, a coordinated regulatory settlement was reached with five firms (Citigroup, HSBC, J.P. Morgan, RBS, and UBS) on November 12, 2014. The CFTC fined them $1.4 billion collectively, and the UK FCA fined the same firms approximately $1.7 billion. The OCC reached settlements on the same day, levying penalties of $350 million on both Citibank, N.A. and J.P. Morgan Chase Bank, N.A. Then, on May 20, 2015, the DOJ announced that it had obtained parent-level guilty pleas from Citigroup, J.P. Morgan, Barclays, and RBS in connection with conspiring to fix bids and offers of euro/U.S. dollar currency pairs in the FX spot market and had fined them $2.5 billion in total. The FX settlement also affected the non-prosecution agreements entered into by UBS and Barclays in relation to LIBOR; UBS and Barclays faced additional penalties and guilty pleas as a result of allegedly violating those agreements. On the same day, the Federal Reserve announced it was imposing fines of more than $1.6 billion, and Barclays settled related claims with the New York State Department of Financial Services, the CFTC, and the FCA, with a combined penalty of approximately $1.3 billion. In total, fines for FX manipulation exceeded $10 billion.

According to the DOJ's factual findings, beginning in at least December 2007, FX traders at large firms communicated with each other in an electronic chat room that they referred to as "The Cartel" or "The Mafia" in order to manipulate WM/R rates. Traders coordinated the "trading of the EUR/USD currency pair in connection with European Central Bank and World Markets/Reuters benchmark currency 'fixes' which occurred at 2:15 PM (CET) and 4:00 PM (GMT) each trading day." Additionally, traders would withhold "bids and offers, when one conspirator held an open risk position, so that the price of the currency traded would not move in a direction adverse to the conspirator with an open risk position." Plea Agreement at 3, 5–6, 16–17, *United States v. Citicorp* (D. Conn. May 20, 2015).

A press account of the alleged manipulation notes:

> One trader with more than a decade of experience said that if he received an order at 3:30 p.m. to sell 1 billion Euros ($1.37 billion) in exchange for Swiss francs at the 4 p.m. fix, he would have two objectives: to sell his own euros at the highest price and also to move

> the rate lower so that at 4 p.m. he could buy the currency from his client at a lower price.
>
> He would profit from the difference between the reference rate and the higher price at which he sold his own euros. A move in the benchmark rate of 2 basis points [0.02 %], would be worth 200,000 francs ($216,000).

Liam Vaughan et al., *Traders Said to Rig Currency Rates to Profit Off Clients*, BLOOMBERG (June 12, 2013).

According to press reports, FX traders would, for example, allegedly manipulate prices by flooding a currency with rush orders, or "banging the close," after communicating in chat rooms to move WM/R rates in a desired direction. Roger Aitken, *FX Rate 'Rigging' Scandal Boiling up After UBS Revelation*, FORBES (Oct. 8, 2014). "Banging the close" occurs when a trader breaks up a large customer order into several smaller orders and processes the many, smaller trades in the moments before and during the 60-second fixing window. Because the WM/R rate is based on the *median* price of transactions, placing a series of smaller trades could have a more significant impact on the WM/R rate than could a large deal. *See* Complaint at 106–107, *In re Foreign Exchange Benchmark Rates Antitrust Litigation*, 74 F. Supp. 3d 581 (S.D.N.Y. 2015).

Traders would also allegedly "paint the screen." Painting the screen involves traders making fake trades with one another in the fix window to give the illusion that real trades are taking place. They could allegedly move the WM/R benchmark in a particular direction. The traders allegedly then immediately reversed the trades following the fix. *Id.* at 108.

Owing to the size of the FX market, a bank acting alone could not profit from banging the close or painting the screen. As a former FX trader at Morgan Stanley and Deutsche Bank argued, it would take "collusion of inordinate magnitude for such a strategy to work reliably and consecutively." Roger Aitken, *FX Rate 'Rigging' Scandal Boiling up After UBS Revelation*, FORBES (Oct. 8, 2014). As in the LIBOR scandal, traders allegedly manipulating the FX markets provided damning (but entertaining) communications, such as "I'd prefer we join forces...perfick...let's do this...lets double team them...YESssssss." CFTC, EXAMPLES OF MISCONDUCT IN PRIVATE CHAT ROOMS, TRADERS FROM TWO BANKS "DOUBLE TEAM" TO ATTEMPT TO MANIPULATE FIX 4 (2014).

3. Private Litigation

Many firms faced scrutiny from private investors. For example, investors filed a class action lawsuit in 2014 against Bank of America, Barclays, BNP Paribas, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, J.P. Morgan, Morgan Stanley, RBS, and UBS. *See In re Foreign Exchange Benchmark Rates Antitrust Litigation*, No. 74 F. Supp. 3d 581 (S.D.N.Y. 2015). Investors alleged that the banks' joint manipulation of the FX market violated § 1 of the Sherman Antitrust Act by combining to restrain commerce in the United States and abroad. Various institutions have settled with investors, including J.P. Morgan for $99.5 million, UBS for $135 million, Bank of America for $180 million, and Citigroup for $394 million. *See* Melissa Lipman, *$5.6B Forex Fines Aren't the End of Rate-Rigging Fallout*, LAW360 (May 20, 2015).

4. Reform

In addition to levying penalties, the CFTC forced the settling firms to reform their FX business practices in ways consistent with the settlement agreements following the LIBOR scandal. These institutions agreed to adopt internal controls to detect and deter improper FX conduct. *See, e.g.*, *In re* Citibank, CFTC Docket No. 15–03, at 12–14. The firms will receive annual audits on their FX business' compliance with applicable regulations, and employees involved in FX must receive training on relevant laws. The later Federal Reserve and OCC orders also contained significant remediation obligations and audits, creating, in essence, a proto-regulatory regime. While not codified in law, the firms' agreement to change their business practices could reflect the beginning of reform in this area. Remediation efforts began long before the regulatory actions were concluded. Barclays, Citigroup, RBS, J.P. Morgan, Deutsche Bank, and UBS have either banned their employees from FX chat rooms or severely limited their access. *See, e.g.*, Daniel Schäfer et al., *Banks Ban Traders From Group Chat Rooms*, CNBC (Nov. 22, 2013). All of the settling institutions, and several other firms, terminated or suspended employees involved in the FX manipulation scandal. *See* Complaint at 151–64, *In re Foreign Exchange Benchmark Rates Antitrust Litigation*, 74 F. Supp. 3d 581 (S.D.N.Y. 2015).

In 2014, the Financial Stability Board (FSB) made recommendations to safeguard the FX market. The FSB proposals included extending the fixing period to five minutes, expanding the number of transactions included in determining the fix, and banning interbank FX communication. FIN. STABILITY BD., FOREIGN EXCHANGE BENCHMARKS (2014).

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1. ***Culture or Subcultures?*** Does the bad behavior in LIBOR and FX reflect the overall culture of the institutions or the fact that certain subcultures existed or were permitted to exist by supervisors and managers? What lessons can be drawn more widely for reforming culture? Is the answer to impose criminal liability on compliance officers, to strengthen compliance and risk management, or to impose executive compensation clawbacks including on senior management? *See* Chapter 8.1. Will any of this work without swift terminations of culpable, but profitable, traders? Reflect as well on whether the overwhelmingly young male culture of the trading floor and its direct supervisors played a role in the development of some of the subcultures. For research on the impact of gendered subcultures and risk-taking, see JOHN COATES, THE HOUR BETWEEN DOG AND WOLF: HOW RISK TAKING TRANSFORMS US, BODY AND MIND (2013).

2. ***Fabulous Fab.*** Recall our discussion in Chapter 4.3 of ABACUS 2007-ACI, the collateralized debt obligation (CDO) that the SEC alleged Goldman Sachs marketed to clients without disclosing that another client, the hedge fund Paulson & Co., had taken the short position on the other side of the deal and therefore wanted the CDO to lose value. This alleged conflict of interest led to a fine of $550 million by the SEC on July 15, 2010. Press Release, SEC, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010). This settlement was followed by a jury verdict against Fabrice Tourre, a junior banker involved in assembling and selling the transaction. *See*

Bob Van Voris, *Ex-Goldman's Tourre Ordered to Pay $825,000 in SEC Case*, BLOOMBERG BUS. (Mar. 12, 2014). As the article notes, "[i]n one e-mail, Tourre...quoted a friend's nickname for him: 'Fabulous Fab.' Tourre referred to the investments he was constructing as 'monstrosities.' In another e-mail, he joked about selling investments in Abacus to 'widows and orphans.'" *Id.*

3. ***Credit Default Swap (CDS) Antitrust Litigation.*** Major banks and broker-dealers in the CDS market, and ISDA, have settled claims by investors relating to alleged anticompetitive practices. *See* Nate Raymond, *JPMorgan, Morgan Stanley to Pay Most in $1.9 Billion Swaps Price-Fixing Settlement,* REUTERS (Oct. 16, 2015). The settlement also included an agreement by ISDA to certain behavioral remedies, as described by Professor Darrell Duffie, who testified as an expert in the case:

> ISDA owns certain intellectual property, including the rights to the settlement prices generated by CDS auctions administered by ISDA...that are necessary for the operation of a viable CDS exchange trading platform. Plaintiffs alleged that ISDA, in collusion with Defendants, refused to grant such licenses to any exchange trading platforms. The changes to its licensing practices that ISDA has now agreed to adopt under the proposed settlement will make it much easier for parties to license ISDA's intellectual property for the exchange trading of CDS.
>
> ISDA has also agreed to a number of measures that will make its licensing process more transparent and inclusive of class members....
>
> I consider these and other terms of the proposed settlement agreement to be important changes that should make the CDS market more transparent, efficient, and competitive....

Decl. Darrell Duffie in support of Pl.s' Motion, Dkt. No. 446, *In re Credit Default Swaps* Antitrust *Litigation*, 13-md-02476 (DLC), Oct. 16, 2015 (S.D.N.Y.). Is this approach to improving ISDA's procedures appropriate? What does the settlement suggest about the role of self-regulatory organizations?

4. ***Settled Regulatory Outcomes.*** In the early stages of an investigation by an enforcement authority, large financial institutions often conduct their own internal investigations. The common process, when problems of the type discussed in this section are uncovered, is for a firm to self-report and then conduct its own internal investigation run by an independent outside counsel. As a result, the firms cooperate with the investigating authorities by providing the evidence of wrongdoing to the authorities and by taking remedial steps to strengthen relevant systems and controls. Firms and regulatory authorities will negotiate factual allegations, terms, and content of published settlement documents. The strength of a firm's bargaining position might be affected by the relationship of the institution with its regulators and the number of other institutions involved. There is no neutral trier of facts in a settlement and the content of the factual allegations is also typically a topic of negotiation. Does the knowledge that facts are negotiated change your view about the context of the settlements? What settlement strategy would you recommend to an institutional client involved in a global investigation with a number of other subjects?

5. ***Too Big to Jail, Revisited?*** The DOJ's LIBOR and FX settlements culminated in guilty pleas from parent-level entities. What does this additional punishment achieve? Federal securities laws and SEC regulations restrict persons or institutions with criminal convictions or regulatory orders from engaging in certain types of fiduciary businesses or from taking advantage of certain exemptions under securities laws. *See, e.g.*, 17 C.F.R. § 230.506(d). The SEC issued waivers for each of the settling banks to ensure that they would not be subject to these restrictions. *See* Securities Act Release Nos. 33-9778–87 (May 20, 2015). This move proved controversial in some quarters. Consider the following dissenting opinion of SEC Commissioner Kara Stein:

Kara M. Stein, Comm'r, SEC, Dissenting Statement Regarding Certain Waivers Granted by the Commission for Certain Entities Pleading Guilty to Criminal Charges Involving Manipulation of Foreign Exchange Rates

(May 21, 2015)

I dissent from the Commission's Orders, issued on May 20, 2015, that granted [UBS, Citigroup, J.P. Morgan, and RBS] waivers from an array of disqualifications required by federal securities regulations....

The disqualifications were triggered for generally the same behavior: a criminal conspiracy to manipulate exchange rates in the foreign currency exchange spot market.... Traders at these firms "entered into and engaged in a combination and conspiracy to fix, stabilize, maintain, increase or decrease the price of, and rig bids and offers for," the euro-dollar foreign currency exchange.... To carry out their scheme, the conspirators communicated and coordinated trading almost daily in an exclusive online chat room that the traders referred to as "The Cartel" or "The Mafia." Additionally, salespeople and traders lied to customers in order to collect undisclosed markups in certain transactions. This criminal behavior went on for years, unchecked and undeterred.

There are compelling reasons to reject these requests to waive the automatic disqualifications required by statute or rule. Chief among them, however, is the recidivism of these institutions....

The [SEC] has thus granted at least 23...waivers to these five institutions in the past nine years. The number climbs higher if you include Bad Actor and other waivers....

Allowing these institutions to continue business as usual, after multiple and serious regulatory and criminal violations, poses risks to investors and the American public that are being ignored....

It is troubling enough to consistently grant waivers for criminal misconduct. It is an order of magnitude more troubling to refuse to enforce our own explicit requirements for such waivers. This type of recidivism and repeated criminal misconduct should lead to revocations of prior waivers, not the granting of a whole new set of waivers. We have the tools, and with the tools the responsibility, to empower those at the top of these institutions to create meaningful cultural shifts, yet we refuse to use them.

In conclusion, I am troubled by repeated instances of noncompliance at these global financial institutions, which may be indicative of a continuing culture that does not adequately support legal and ethical behavior. Further, I am concerned that the latest series of actions has effectively rendered criminal convictions of financial institutions largely symbolic. Firms and institutions increasingly rely on the [SEC's] repeated issuance of waivers to remove the consequences of a criminal conviction, consequences that may actually positively contribute to a firm's compliance and conduct going forward.

SEC Commissioner Daniel Gallagher defended the use of waivers on the ground that the SEC has traditionally used waivers as a tool to reduce recidivism, rather than as a part of the sanctioning process. Daniel M. Gallagher, SEC Comm'r, Why is the SEC Wavering on Waivers? Remarks at the 37th Annual Conference on Securities Regulation and Business Law (Feb. 13, 2015). What would have happened to the mutual fund market if the SEC had not issued waivers?

C. ENFORCEMENT UNDER TITLE VII

When a new regulatory regime is built, enforcement generally does not begin immediately. During the flurry of activity to implement Dodd-Frank, the CFTC signaled that market participants must engage in good-faith efforts to meet the regulatory requirements applicable to them. *See* Final Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 858 (Jan. 7, 2013). More than two years after the majority of the swap regulations went into effect, the CFTC began to bring public enforcement actions against SDs for failure to comply with these regulations, the first of which was announced in 2015.

As of 2020, the CFTC had announced 28 enforcement actions against swap dealers. Anne M. Termina, Uttara Dukkipati & B. Graves Lee, *Managing the Risk: An Overview of CFTC Swap Dealer Enforcement Actions Under Dodd-Frank*, 53 REV. OF SEC. & COMMODITIES REG. 1 (Aug. 3, 2020). Seven actions were filed in 2019 alone against swap dealers for violating swap data reporting rules. *Division of Enforcement FY 2019 Annual Report*, CFTC (Nov. 25, 2019). In 2020, the CFTC brought the largest monetary penalty against a swap dealer in its history. *Division of Enforcement FY 2020 Annual Report*, CFTC (Dec. 1, 2020).

The CFTC has also used the anti-manipulation authority provided in § 753 of the Dodd-Frank Act and CFTC Rule 180.1. *See* 17 C.F.R. § 180.1. This framework mirrors the insider trading regime in the Securities Exchange Act and SEC Rule 10b-5. The CFTC may use its authority to pursue traders who use material non-public information. *See, e.g.*, CFTC, In the Matter of Arya Motazedi, Order Instituting Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions (Dec. 2, 2015); *see also* Yesha Yadav, *Insider Trading in Derivatives Markets*, 103 GEO. L.J. 381 (2015).

In 2015, the SEC brought its first enforcement case for violations of security-based swap requirements under Title VII. This action was against a web-based exchange that allowed members to buy and sell contracts in fantasy stocks based on the potential future value of pre-initial public offering company stocks. The SEC classified these contracts as security-based swaps, which are required to be traded on an exchange, see Chapter 11.2, unless the customer is an eligible contract participant. The exchange paid a $20,000 civil penalty. *See* In the Matter of Sand Hill Exchange, Gerrit Hall & Elaine Ou, Release No. 9809 (June 17, 2015). This enforcement action demonstrates the SEC's willingness to bring enforcement actions for violations of Title VII even when the SEC had not yet finalized many of its security-based swap regulations and the volume of transactions was small.

In 2020, J.P. Morgan settled charges brought by the CFTC, SEC, and DOJ for manipulative trading, and admitted wrongdoing. From at least 2008 to 2016, J.P.

Morgan traders placed hundreds of thousands of orders in the commodities and Treasury markets with the intent to cancel them before they were executed. This practice is known as "spoofing." *See* Michael Barr & Gabriel Rauterberg, Regulating Manipulation by Algorithms (July 29, 2020) (unpublished manuscript) (on file with author); *see also* Elaine Wah, Michael Barr, Uday Rajan & Michael P. Wellman, Comment Letter on CFTC Concept Release on Risk Controls and System Safeguards for Automated Trading Environments (Dec. 11, 2013). The orders created the false appearance of market movement, designed to deceive market participants into executing the actual orders J.P. Morgan wanted filled at artificial prices. The CFTC ordered J.P. Morgan to pay $920 million, the largest monetary penalty ever imposed by the agency. In a parallel criminal investigation, J.P. Morgan entered into a deferred prosecution agreement with the DOJ on wire fraud charges and agreed to pay a criminal fine, disgorgement, and restitution. It also settled a parallel matter with the SEC, in which J.P. Morgan will pay disgorgement and a civil monetary penalty. Press Release, CFTC, CFTC Orders J.P. Morgan to Pay Record $920 Million for Spoofing and Manipulation (Sept. 29, 2020); Deferred Prosecution Agreement, *United States v. J.P. Morgan Chase & Co.* (D. Conn. Sept. 25, 2020).

IV. THE EXTRATERRITORIAL REACH OF TITLE VII

As you have seen, swap market participants frequently transact across jurisdictions. In fact, more than half of all swap transactions involve a U.S. counterparty on one side and a non-U.S. counterparty on the other side. SDs have trading desks across the world. As the LIBOR and FX actions suggest, regulators and enforcement agencies across multiple jurisdictions may become involved in policing misconduct. The international nature of this market raises critically important issues of the extraterritorial scope of U.S. rules.

A. WHY IS CROSS-BORDER REGULATION NEEDED?

During the Financial Crisis, U.S. markets were significantly affected by derivatives trading overseas. AIG nearly failed because of the risks incurred by the London swap trading operations of its subsidiary AIG Financial Products. Lehman Brothers, at the time of its bankruptcy, guaranteed approximately 130,000 derivatives contracts of its UK subsidiary, Lehman Brothers International (Europe). The relationships between these U.S. corporations and their European subsidiaries are examples of how risk can be transferred across jurisdictional borders when multinational affiliated entities are involved and how these risks can affect the U.S. markets. *See* ROSALIND Z. WIGGINS & ANDREW METRICK, THE LEHMAN BROTHERS BANKRUPTCY G: THE SPECIAL CASE OF DERIVATIVES 14 (2014). As former CFTC Chair Gary Gensler stated, "[d]uring a default or crisis, the risk that builds up offshore inevitably comes crashing back onto U.S. shores" and thus, without cross-border regulation and coordination, U.S. markets can be significantly affected by overseas activities. *See* Gary Gensler, Chair, CFTC, Statement of Support on Final Exemptive Order Regarding Compliance with Certain Swap Regulations and Further Proposed Guidance (Dec. 21, 2012).

There are, however, several arguments against extending U.S. regulations to non-U.S. participants. Cross-border regulation may interfere with the regulation

of similar markets in other jurisdictions and may conflict with the principle of international comity. *See* Scott O'Malia, Comm'r, CFTC, Keynote Address Before OpRisk Europe Conference: Taking the Time to Get It Right: The Cross-Border Regulatory Framework (June 12, 2013). Additionally, implementing regulatory regimes for OTC derivatives in various jurisdictions could subject participants to multiple sets of regulation for the same activity. Even in situations where the United States has an interest in regulating activity, other jurisdictions may also, and determining which regulatory regime applies, if not both, is often unclear. Recognizing the desirability of harmonization of global standards, the Dodd-Frank Act requires the regulators to "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards...." Dodd-Frank Act § 752(a), 15 U.S.C. § 8325(a).

B. CROSS-BORDER APPLICATION OF TITLE VII

Title VII includes two provisions that explicitly define its cross-border scope. Section 2(i) of the CEA provides that the provisions of the CEA that relate to swaps (and the rules adopted under the CEA) would 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 the rules and regulations as prescribed or promulgated by the CFTC as are necessary to prevent the evasion of any provision of the CEA that was enacted by the Dodd-Frank Act. Section 30(c) of the 1934 Act addresses the territorial scope of Title VII's security-based swap provisions. It provides that the 1934 Act and any related rule will not apply to any person that transacts in security-based swaps "without the jurisdiction of the United States, unless such person transacts such business in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent the evasion of any provision...."

These provisions make it clear that a swap or security-based swap between two U.S. entities is subject to Title VII and a swap between two entities with absolutely no nexus to the United States is not subject to Title VII, but is silent on the large number of transactions that fall in between. When will a non-U.S. activity have a nexus to the United States? When will such activity have a "direct and significant connection with, or effect on," U.S. commerce?

1. The CFTC's Cross-Border Approach

To address the scope of the cross-border application of Title VII, the CFTC adopted the Cross-Border Guidance in 2013, which was superseded in part by rulemaking in 2020. The Cross-Border Guidance generally applies the full set of the CFTC's Title VII requirements if at least one counterparty to the swap is a U.S. person. As a result, the counterparties to an interest rate swap between a U.S. bank and a German swap dealer would generally be subject to the CFTC's requirements. The definition of "U.S. person" in the Cross-Border Guidance is quite expansive and does not mirror definitions used in earlier CFTC or SEC rules. An entity can be a U.S. person under the Cross-Border Guidance, and thus subject to CFTC regulations, while also being a non-U.S. person under SEC rules. In addition, the Cross-Border Guidance applies Title VII requirements in certain situations where neither counterparty is a U.S. person, for example, if

the obligations of both counterparties under the swap are guaranteed by a U.S. person.

The Cross-Border Guidance divides CFTC swap regulations into two categories: Entity-Level Requirements and Transaction-Level Requirements. Entity-Level Requirements generally apply to entities that are registered with the CFTC as SDs or MSPs. Transaction-Level Requirements apply to individual transactions or trading relationships between counterparties. Whether a CFTC rule will apply to a particular swap transaction between two counterparties depends on whether one or both of the counterparties meet the definition of U.S. person, whether the requirement is an Entity-Level Requirement or a Transaction-Level Requirement, and whether the counterparties are SDs, MSPs, or another category of counterparty, such as affiliates guaranteed by a U.S. entity, or conduit affiliates, those who engage in swaps with non-U.S. third parties for the purpose of hedging risks faced by its U.S. affiliate.

The Cross-Border Guidance is guidance from the CFTC and does not have the force of formal rulemaking. The CFTC has argued that, because the cross-border application of its substantive rules is issued in the form of guidance, as opposed to a formal rule, market participants are provided with additional flexibility to interpret and apply the statutory provisions addressing the cross-border application of Title VII. *See id.* at 45,297. Market participants have argued that, notwithstanding its status as guidance, the Cross-Border Guidance is a *de facto* rulemaking that participants are still required to comply with as if it were a final rule. In 2013, three trade associations that represent market participants filed a lawsuit against the CFTC challenging the Cross-Border Guidance. Although the action was dismissed, the excerpt below summarizes the concerns market participants had over the application of the Cross-Border Guidance.

Sec. Indus. & Fin. Mkts. Ass'n v. CFTC

67 F. Supp. 3d 373 (D.D.C. 2014)

Plaintiffs argue that the Cross-Border Action is a legislative rule because—both on its face and in practice—it is binding upon the CFTC and market participants. Pls.' Mot. at 23–28. The CFTC counters that the Cross-Border Action—as the agency has proclaimed since its promulgation—is a non-binding general statement of policy intended to "communicate its views and intentions" to the regulated community regarding the scope of the Title VII Rules' extraterritorial applications. CFTC Mot. at 31, 24–34. Having considered the parties arguments, the controlling case law, the record before the Court, and—most importantly—the Cross-Border Action itself, the Court agrees with the CFTC that—save for a four-page portion of the Cross-Border Action [related to an interpretive rule on jurisdictional nexus]—the Cross-Border Action is a policy statement.

For starters, the Cross-Border Action on its face is binding on neither the CFTC nor swaps market participants. The Cross-Border Action, when read in its entirety, does not "purport to carry the force of law." *See Ctr. for Auto Safety v. Nat'l Highway Traffic Safety Admin.,* 452 F.3d 798, 808 (D.C. Cir. 2006). It "does not 'command[,]' does not 'require[,]' does not 'order[,]' and does not 'dictate[.]'" *Cement Kiln,* 493 F.3d at 228 (alterations in original) (quoting *Appalachian Power Co. v. EPA,* 208 F.3d 1015, 1023 (D.C. Cir. 2000)). Indeed, from its first pages, the Cross-Border Action explicitly distinguishes itself from a "binding rule." 78 Fed. Reg. at 45,297. Instead of "stat[ing] with precision when particular requirements do and do not apply to particular situations," it announces the CFTC's

"general policy regarding cross-border swap activities and allows for flexibility in application to various situations, including consideration of all relevant facts and circumstances that are not explicitly discussed in the guidance." *Id.* (footnote omitted). Although the Cross-Border Action does convey to market participants "how [the CFTC] ordinarily expects to apply existing law and regulations in the cross-border context," it also makes clear that when determining whether to apply the Title VII Rules extraterritorially, the CFTC "will apply the relevant statutory provisions, including CEA section 2(i), and regulations to the particular facts and circumstances" and parties may "present facts and circumstances that would inform the application of the substantive policy positions set forth in this release." *Id.* The Cross-Border Action further emphasizes that the CFTC's policy positions are tentative and subject to change as "foreign regulatory regimes and the global swaps market continue to evolve." *Id.* This flexible, non-binding approach continues throughout the substantive portions of the Cross-Border Action. *Sec. Indus. & Fin. Markets Ass'n v. United States Commodity Futures Trading Comm'n,* 67 F. Supp. 3d 373, 417–18 (D.D.C. 2014).

In 2016, the CFTC proposed cross-border rules. Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71,946 (Oct. 18, 2016). The CFTC replaced this proposal with new proposed rules in January 2020, which were finalized in July 2020 by a 3-2 vote. Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants, 85 Fed. Reg. 952 (Jan. 8, 2020); Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants, 85 Fed. Reg. 56,924 (Sept. 14, 2020). Deferring to foreign regulators to oversee swap activities of foreign subsidiaries of U.S. firms, the CFTC stated it "will be guided by international comity principles and will focus its authority on potential significant risks of the U.S. financial system." Heath P. Tarbert, Chair, CFTC, Statement in Support of Amending the Registration Exemption for Foreign CPOs (May 28, 2020). This approach, according to the CFTC, generally aligns with its existing practice to defer to foreign regulators with comparable requirements and furthers Dodd-Frank's goal for the CFTC to work with foreign regulators to establish consistent global swap regulations. The final rule codifies the treatment of many of the swap entity requirements under the Cross-Border Guidance and similarly divides certain regulations into groups. *CFTC Finalizes New Cross-Border Swap Rules, But How Much Has Changed?*, CLEARY GOTTLIEB (July 29, 2020). Group A includes requirements related to chief compliance officers, risk management, swap data recordkeeping, and antitrust considerations. Group B includes requirements related to swap trading relationship documentation, portfolio reconciliation and compression, trade confirmation, and daily trading records. Group C includes business conduct rules and rules related to segregation of initial margin held as collateral for uncleared swaps. Whether an exemption or substituted compliance is available for a specific requirement will depend upon which group it falls under.

Commissioners in favor of the final rule acknowledged the global progress in implementing G20 swap reforms and potential inefficiencies from duplicative requirements between U.S. and foreign regulators. The dissenting commissioners believe such a deferential approach will leave some activities unregulated and

harm U.S. markets. Notably, Commissioner Berkovitz remarked that the rule allows banks to evade Dodd-Frank requirements and "will provide no protections…from the swap activities of overseas affiliates of U.S. entities that bring risks to their U.S. parents and to the U.S. financial system." Dan Berkovitz, Comm'r, CFTC, Dissenting Statement on the Final Rule for Cross-Border Swap Activity of Swap Dealers and Major Swap Participant (July 23, 2020). Other critics of the rule believe the rule "recklessly outsources the protection of American taxpayers to foreign regulators" and shifts the risk of foreign swap activities from large institutions to taxpayers. Dennis M. Kelleher, *The CFTC Recklessly Outsources the Protection of American Taxpayers to Foreign Regulators Who Have Repeatedly Failed to Protect Their Own Taxpayers*, BETTER MKTS. (July 23, 2020).

2. The SEC's Cross-Border Approach

The SEC has also finalized rules regarding the cross-border application of its security-based swap requirements, including the definition of a U.S. person. The SEC's U.S. person definition is consistent with the definition the CFTC outlined in its final rule. The SEC also published a proposal that would apply certain requirements to transactions between non-U.S. persons if portions of the conduct occur within the United States. For example, a security-based swap between two non-U.S. counterparties would be subject to the SEC requirements if either counterparty has U.S. personnel involved in negotiating the transaction. For a critique of the SEC's approach, see John C. Coffee, Jr., *Extraterritorial Financial Regulation: Why E.T. Can't Come Home,* 99 CORNELL L. REV. 1259, 1285 (2014) (arguing that SEC's approach would permit firms to issue implicit guarantees to evade U.S. rules).

In 2019, in response to critiques that its rules imposed disruptive and costly burdens on market participants, the SEC adopted amended rules to provide guidance on transactions that have been arranged, negotiated, or executed by U.S. personnel. It also amends the requirement for nonresident security-based swap entities to submit a certification and an opinion of counsel stating that they can provide the SEC with access to their books and records. The new rules also set the compliance date for SBSDs and MSBSPs to register with the SEC. Press Release, SEC, SEC Adopts Actions to Stand Up Security-Based Swap Regulatory Regime (Dec. 18, 2019); Cross-Border Application of Certain Security-Based Swap Requirements, 85 Fed. Reg. 6,270 (Feb. 4, 2020).

C. SUBSTITUTED COMPLIANCE

There are a number of reasons for U.S. regulators to apply U.S. rules to transactions where one or both parties is located outside the United States. In a situation where the United States and a foreign jurisdiction both would apply their rules to a single transaction, how should market participants comply with rules that may be duplicative or in conflict? One solution is for regulators to ensure their rules are identical, but this requires significant collaboration and may remain impossible given differences in the underlying legal regimes. *See generally* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31 (2007).

Another solution to the problem of overlapping regulatory regimes is for one jurisdiction to defer to the other. A broad form of such deference is mutual

recognition, under which one country may agree to accept the rules of another country based on mutuality, without regard to whether the substantive rules of the other country are identical, or even harmonized, with its own. Under a narrower form of mutual recognition, one country agrees to accept the rules of another country if the other country's rules are sufficiently harmonized with its own rules that they may be deemed equivalent or comparable. In this vein, the CFTC and the SEC have contemplated a system, known as substituted compliance, where compliance with a comparable local law in a non-U.S. regime may be permissible in lieu of compliance with the relevant U.S. regime. While substituted compliance is a worthwhile goal, its implementation can be quite difficult. *See* Howell E. Jackson, *Substituted Compliance: The Emergence, Challenges, and Evolution of a New Regulatory Paradigm*, 1 J. FIN. REG. 169 (2015); *see also* Alexey Artamonov, *Cross-Border Application of OTC Derivatives Rules: Revisiting the Substituted Compliance Approach*, 1 J. FIN. REG. 206 (2015).

In the Cross-Border Guidance, the CFTC describes how it will determine substituted compliance. Under the Guidance, a non-U.S. person may submit an application for substituted compliance to the CFTC. In making a substituted compliance determination, the CFTC will consider the non-U.S. jurisdiction's objectives and will base its analysis on a comparison of the specific non-U.S. requirements against the specific CFTC requirements. A substituted compliance determination will be made on a requirement-by-requirement basis, rather than at the level of the non-U.S. regime as a whole. For example, with respect to the portfolio reconciliation and compression requirements discussed in this Chapter, the CFTC has determined that the EU's requirements are comparable to and as comprehensive as the CFTC's requirements. The CFTC granted requests for comparability determinations for certain requirements that apply to participants in Australia, Canada, the EU, Hong Kong, Japan, and Switzerland. *See* Press Release, CFTC, CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes (Dec. 20, 2013).

In 2017, CFTC Chair J. Christopher Giancarlo stated that deference to comparable foreign regulatory frameworks was the optimal approach, and that the CFTC would "make more explicit in our cross-border rules that the CFTC will defer to the rules of comparable foreign jurisdictions." J. Christopher Giancarlo, Chair, CFTC, Remarks Before the Eurofi Financial Forum: Future of CFTC-EU Regulatory Coordination in the Financial Sector (Sept. 14, 2017). The CFTC issued a determination finding EU margin requirements comparable to those under U.S. law. Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 82 Fed. Reg. 48,394 (Oct. 18, 2017). The European Commission issued a similar equivalence determination for the CFTC's margin requirements but not for the requirements of the banking regulators. EUROPEAN COMM'N IMPLEMENTING DECISION (EU) 2017/1857 (Oct. 13, 2017). In 2017, the CFTC and the European Commission also agreed to a common approach regarding trading venues. The CFTC thereafter issued an order approving an exemption from swap execution facility registration for trading venues organized within the EU. CFTC, In the Matter of the Exemption of Multilateral Trading Facilities and Organised Trading Facilities Authorized Within The European Union from the Requirement to Register with the Commodity Futures Trading Commission as Swap Execution Facilities, Order of

Exemption (Dec. 8, 2017). The European Commission found that U.S. trade execution rules were comparable to European rules, permitting European firms to trade on U.S. platforms. EUROPEAN COMM'N IMPLEMENTING DECISION (EU) 2017/2238 (Dec. 5, 2017). In 2020, the CFTC approved a final rule that established a framework for substituted compliance, as well as a formal process for requesting comparability determinations. Cross-Border Application of the Registration Thresholds and Certain Requirements Applicable to Swap Dealers and Major Swap Participants, 85 Fed. Reg. 56,924 (Sept. 14, 2020).

The SEC has issued rules making substituted compliance available for (1) recordkeeping and reporting requirements, (2) capital and margin requirements, and (3) portfolio reconciliation, portfolio compression, and trading relationship documentation requirements. Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers, 84 Fed. Reg. 68,550 (Dec. 16, 2019); Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 Fed. Reg. 43,872 (Aug. 22, 2019); Risk Mitigation Techniques for Uncleared Security-Based Swaps, 85 Fed. Reg. 6,359 (Feb. 4, 2020).

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1. ***Cross-Border Regulation.*** What alternative solutions could the CFTC and SEC have used to address the cross-border regulatory problem? Should regulators apply domestic law to cross-border transactions and foreign-based subsidiaries of U.S. entities, defer to foreign law, or seek to harmonize domestic and foreign law?

2. ***Comparing Foreign Laws to U.S. Requirements.*** What factors should the CFTC and SEC consider when comparing foreign laws to U.S. requirements to determine if they are comparable? Do you think this approach is workable?

3. ***EU Response Post-Brexit.*** The EU has a substituted compliance framework for non-EU (third-country) firms. In 2019, the EU amended its regulations to tailor the treatment of firms based on the scale and scope of their services, subjecting those deemed to be of systemic importance to greater scrutiny. Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014, 2019 O.J. (L 314) 1 (*IFR*). As we discussed in Chapter 11.2, Brexit and the EU's response could significantly affect U.S. markets and potentially fragment the global financial system. EU regulations could make it more difficult for UK firms—and U.S. firms doing business abroad—to receive equivalence determinations following the end of the Brexit transition period. Without substituted compliance, market participants could face higher regulatory costs and operational difficulties. *The Impact of Brexit on OTC Derivatives*, ISDA (July 2020). Given the importance of the UK market, vastly different rules in the UK could also impede G-20 efforts to establish consistent global standards for regulating derivatives.
