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Cover Page Footnote

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OVER-THE-COUNTER DERIVATIVES IN A GLOBAL FINANCIAL MARKETPLACE: THE CASE FOR UNIFORM GLOBAL IDENTIFIERS AND COMPATIBLE REPORTING REQUIREMENTS IN SUBSTITUTED COMPLIANCE COMPARABILITY DETERMINATIONS

Kimberly R. Thomasson[+]

The fall of 2008 now stands as a dark memory of the effects of unregulated, non-transparent, risky financial instruments. Investors lost trillions of dollars in the U.S. stock market as panic set in after the collapse of Lehman Brothers,[1] one of the oldest and most respected investment banks on Wall Street, and the near collapse of American International Group (AIG).[2] Lehman and AIG, like many other financial entities prior to the 2008 recession, entered into unregulated over-the-counter (OTC) derivative contracts linked to sub-prime mortgage-backed securities.[3] Upon the unthinkable collapse of the U.S. housing market, payment on certain derivative contracts, such as credit default swaps, were triggered.[4]

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1. *See* Henry C. K. Liu, *The Crisis of Wealth Destruction*, ROOSEVELT INST. (Apr. 7, 2010), http://www.rooseveltinstitute.org/new-roosevelt/crisis-wealth-destruction (recounting that U.S. households lost almost $8 trillion of wealth in the stock market, and that the financial crisis destroyed $34.4 trillion of global wealth).

2. *See* Stephen Foley, *Crash! Shares Tumble as Lehman Collapses and Fears Grow for AIG*, INDEPENDENT (Sept. 16, 2008), http://www.independent.co.uk/news/business/news/crash-shares-tumble-as-lehman-brothers-collapses-and-fears-grow-for-aig-931981.html (explaining that "as panic selling spread during the afternoon [of the first trading day following Lehman Brothers' declaration of bankruptcy] on Wall Street, the Dow Jones Industrial Average of leading US shares ended down over 500 points").

3. *See The Origins of the Financial Crisis*, ECONOMIST (Sept. 7, 2013), http://www.economist.com/news/schoolsbrief/21584534-effects-financial-crisis-are-still-being-felt-five-year s-article (describing how "[c]omplex chains of debt . . . such as credit default swaps" created concentrated risk).

4. THE FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xxv (Jan. 2011), http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (stating that "[w]hen the housing bubble popped and crisis followed,

However, counterparties were vastly undercapitalized and unable to pay the enormous amounts due.[5] The U.S. government stepped in to curb the spiraling trend of defaults on these contracts by lending billions in taxpayer dollars.[6]

The fallout following the collapse of the U.S. housing market reverberated around the world, igniting a global financial crisis.[7] The economic contagion spread, prompting many international governments to intervene and rescue institutions that bought U.S. sub-prime mortgage-backed securities and other unregulated derivative contracts.[8] OTC derivatives operated in a completely opaque market, which was the result of decades of a "free market" regulatory philosophy embraced by policymakers.[9] Only after an economic event so devastating that it rivaled the Great Depression did Congress seek to impose regulation.[10]

In 2009, the world's leaders convened at the G20 Summit in Pittsburgh, Pennsylvania, committed to bringing transparency to the OTC derivatives market through global cooperation.[11] In 2010, Congress responded by passing the Dodd-Frank Wall Street Reform and Consumer Protection Act, which adopted many of the principles agreed upon at the 2009 G20 summit.[12] The Dodd-Frank Act mandates both the Commodity Futures Trading Commission

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derivatives were in the center of the storm"). Under a credit default swap, payment is triggered whenever a credit event, such as a partial default on a mortgage, occurs. *See id.* at 50.

5. *See id.* (explaining that because credit default swaps were not regulated as either insurance contracts or OTC derivatives, counterparties were not required to provide any initial collateral or set aside capital to absorb any potential losses).

6. *See* Matthew Karnitschnig et al., *U.S. To Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J. (Sept. 16, 2008, 11:59 PM), http://online.wsj.com/articles/SB122156561931242905 (explaining that the Federal Reserve would lend $85 billion in taxpayer dollars and in return receive a 79.9% equity stake in the company). Former Chairman of AIG, Maurice Greenberg, later brought suit against the Government alleging that it had no authority to require an equity stake as collateral for the loan. *See* Starr Int'l Co. v. United States, 121 Fed. Cl. 428, 475 (2015) (holding that while the Government acted illegally, shareholders were not harmed by the Government's action).

7. *See The Origins of the Financial Crisis*, *supra* note 3.

8. *See id.*

9. *See* Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. CIN. L. REV. 1283, 1420–25 (2013).

10. Pedro Nicolaci Da Costa, *Bernanke: 2008 Meltdown Was Worse Than Great Depression*, WALL ST. J. (Aug. 26, 2014, 4:03 PM), http://blogs.wsj.com/economics/2014/08/26/2008-meltdown-was-worse-than-great-depression-bernanke-says/.

11. *See G-20 Leaders' Statement: The Pittsburgh Summit*, preamble para. 17 (Sept. 24–25, 2009), http://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf.

12. *See* Jacek Kubas, G20 Deadline on OTC Derivatives—Where Are We Now?, (May 30, 2012) (unpublished manuscript) (on file with author) (stating the deadline for implementing the G20 commitments was the end of 2012 and may have been too ambitious); *see also* FIN. STABILITY BD., OTC DERIVATIVES MARKET REFORMS: EIGHTH PROGRESS REPORT ON IMPLEMENTATION 1 (Nov. 7, 2014), http://www.financialstability board.org/wp-content/uploads/8th-OTC-derivatives-progress-report-for-publication-7Nov.pdf (noting that the "implementation of detailed regulations varies across jurisdictions" and "timetables stretch well into 2015 and beyond").

(CFTC) and the Securities and Exchange Commission (SEC) to consult and coordinate with domestic and foreign regulators in promulgating rules affecting OTC derivatives.[13]

In addition to the Dodd-Frank Act, the Secretary General of the International Organization of Securities Commissions called for a uniform global regulatory regime for OTC derivatives.[14] The CFTC and SEC proposed a framework of "substituted compliance" as a first step in achieving global cooperation.[15] Given the interconnectedness of the derivatives market, the CFTC and SEC will allow a market participant, otherwise subject to rules under Dodd-Frank in a cross-border derivatives transaction, to substitute compliance with its home country's financial regulatory regime.[16] The European Union has adopted similar proposals.[17] Ensuring uniformity of data and compatible reporting requirements will be central to the success of global coordination in OTC derivative reform.

This Comment will analyze both the United States and the European Union approaches to OTC derivatives regulation and propose a solution to making substituted compliance determinations in a global regulatory framework. Part I of this Comment surveys the history of derivatives regulation in the United States, highlights swaps as the type of derivative targeted by global regulators, and discusses current rulemaking efforts by the CFTC, SEC, and European Commission. Part II of this Comment then analyzes these current rulemaking efforts by comparing and contrasting the regulatory agencies' respective approaches. This Comment concludes with a proposal highlighting the importance of uniform data identifiers in swap trade reporting when making substituted compliance determinations regarding OTC derivatives regulations.

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13. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 752(a), 124 Stat. 1376, 1749 (2010) (codified at 15 U.S.C. § 8325 (2012)).

14. David Wright, Sec'y Gen. of IOSCO, Remarks at the Atlantic Council in Washington, D.C. (Dec. 10, 2012), http://www.iosco.org/library/speeches/pdf/20121210-Wright-David.pdf.

15. *See* Interpretive Guidance and Policy Statement Regarding Compliance With Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,340 (July 26, 2013) (to be codified at 17 C.F.R. ch. 1) [hereinafter Interpretive Guidance]; *see also* Cross-Border Security-Based Swap Activities, 78 Fed. Reg. 30,968, 30,975 (May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, and 249) [hereinafter Cross-Border Security-Based Swap Activities]. The concept of "substituted compliance" was first developed by Ethiopis Tafara and Robert J. Peterson. *See generally* Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to United States Investors: A New International Framework*, 48 HARV. INT'L L. J. 31, 32, 67–68 (2007).

16. *See* Interpretive Guidance, 78 Fed. Reg. at 45,342–43; *see also* Cross-Border Security-Based Swap Activities, 78 Fed. Reg. at 31,094–95.

17. *See generally* Regulation (EU) 648/2012, 2012 O.J. (L 201) 1 (commonly referred to as the "European Market Infrastructure Regulation" or "EMIR"); Directive 2014/65/EU, 2014 O.J. (L 173) 349 (commonly referred to as the "Markets in Financial Instruments Directive" or "MiFID II"); Regulation (EU) 600/2014, 2014 O.J. (L 173) 84 (commonly referred to as the "Markets in Financial Instruments Regulation" or "MiFIR"); Directive 2014/57/EU, 2014 O.J. (L 173) 179 (commonly referred to as the "Market Abuse Directive").

I. A HISTORY OF DERIVATIVES REGULATION, SUBSEQUENT DEREGULATORY EFFORTS, AND THE REGULATORY RESPONSE TO THE GLOBAL FINANCIAL CRISIS

A. What Is a Derivative? Grain Futures as an Early Example

Although many scholars disagree on the exact definition,[18] a derivative is most commonly understood as a "financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity."[19] The earliest use of derivatives in the United States can be traced back to nineteenth century agricultural futures trading.[20] Grain and other commodities were transported by Midwestern farmers to Chicago where they were sold to merchants and stored for later shipment to large cities in the East.[21] Due to the boom and bust nature of the grain-harvesting season, coupled with the complications inherent in storing perishable goods, farmers and merchants used futures contracts to mitigate storage costs and hedge against price risks.[22] The farmer and merchant would agree on a fixed price in early summer for the future delivery of grain after the fall harvest.[23] These futures contracts enabled the farmer and the merchant to lock-in the price of grain prior to delivery.[24] Almost immediately, futures contracts began trading on the Chicago Board of Trade, a newly-created futures exchange.[25]

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18. *See* RAFFAELE SCALCIONE, THE DERIVATIVES REVOLUTION: A TRAPPED INNOVATION AND A BLUEPRINT FOR REGULATORY REFORM 130 (2011).

19. *Derivative*, BLACK'S LAW DICTIONARY 509 (9th ed. 2009); *see also* Procter & Gamble Co. v. Bankers Trust Co., 925 F.Supp. 1270, 1275 (S.D. Ohio 1996) (stating that "[d]erivatives transactions may be based on the value of foreign currency, U.S. Treasury bonds, stock indexes, or interest rates. The values of these underlying financial instruments are determined by market forces, such as movements in interest rates. Within the broad panoply of derivatives transactions are numerous innovative financial instruments whose objectives may include a hedge against market risks, management of assets and liabilities, or lowering of funding costs; derivatives may also be used as speculation for profit").

20. *See* JAMES HAMILTON ET AL., A GUIDE TO FEDERAL REGULATION OF DERIVATIVES 13 (Mary Tonah ed. 1998) (explaining that agricultural futures trading "developed in response to the economic need for centralized pricing and large-scale risk bearing").

21. *See* R. STAFFORD JOHNSON, EQUITY MARKETS AND PORTFOLIO ANALYSIS 623 (2014).

22. *See id.*

23. *See id.*; *see also Futures Contract*, BLACK'S LAW DICTIONARY 746 (9th ed. 2009) (defining a futures contract as "[a]n agreement to buy or sell a standardized asset (such as a commodity, stock, or foreign currency) at a fixed price at a future time").

24. *See* JOHNSON, *supra* note 21, at 623.

25. *See Timeline of CME Achievements*, CME GROUP, http://www.cmegroup.com/company/history/timeline-of-achievements.html (last visited Jan. 30, 2016).

B. Exchange-Traded vs. OTC Derivative Contracts: What Is the Difference?

Derivative contracts occur generally in two forms: exchange-traded or OTC.[26] Exchange-traded derivatives are highly standardized contracts with little room for customization.[27] Typically in exchange-traded derivatives, a buyer has only the power to determine the underlying asset, the settlement amount, the maturity date, and the strike price.[28] Additionally, by virtue of trading on an exchange, counterparties to a contract interact with an intermediary (i.e., a clearinghouse[29]) that provides order execution,[30] trade clearing,[31] trade settlement, and credit support, among other services.[32] A futures contract is one example of an exchange-traded derivative.[33]

In contrast, OTC derivatives are bilateral contracts negotiated by the parties in private and without the use of an intermediary.[34] Unlike the standardized nature of exchange-traded derivatives, the permutations in terms of OTC derivative contracts are infinite.[35] Because there is no clearinghouse, counterparties to an OTC derivative contract are subject to ongoing credit risk and do not have the benefit of third party monitoring.[36] OTC derivatives operate in a largely non-transparent market because the transaction is not reported to any exchange.[37] Swaps are an example of an OTC derivative.[38]

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26. *See* Sean J. Griffith, *Substituted Compliance and Systemic Risk: How To Make a Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291, 1297 (2014).

27. *See id.*

28. *See id.*

29. *See Clearing House*, INVESTOPEDIA, http://www.investopedia.com/terms/c/clearinghouse.asp (last visited Jan. 30, 2016) (defining a clearinghouse as "[a]n agency or separate corporation of a futures exchange . . . [that] act[s] as [a] third part[y] to all futures and options contracts—as a buyer to every clearing member seller and a seller to every clearing member buyer").

30. *See Execution*, INVESTOPEDIA, http://www.investopedia.com/terms/e/execution.asp (last visited Jan. 30, 2016) (defining "execution" as "[t]he completion of a buy or sell order for a security").

31. *See Clearing*, INVESTOPEDIA, http://www.investopedia.com/terms/c/clearing.asp (last visited Jan. 30, 2016) (defining "clearing" as "[t]he procedure by which an organization acts as an intermediary and assumes the role of a buyer and seller for transactions in order to reconcile orders between transacting parties").

32. *See* Griffith, *supra* note 26, at 1297.

33. *See supra* notes 20–25 and accompanying text.

34. *See* Griffith, *supra* note 26, at 1298.

35. *See id.*

36. *See id.*; *see also* JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 25–26 (12th ed. 2012) (explaining that "[t]he purpose of requiring a clearinghouse is that it eliminates the credit party risk for each participant because the clearinghouse would assume financial responsibility for the transaction if either party became insolvent or defaulted").

37. *See* COFFEE, JR. & SALE, *supra* note 36, at 25.

38. *See Product Descriptions and Frequently Asked Questions*, INT'L SWAPS & DERIVATIVES ASS'N, INC., http://www.isda.org/educat/faqs.html#10 (last visited Jan. 30, 2016).

C. Bilateral OTC Derivatives and the Credit Default Swap: Ushering in a Wave of Financial Innovation and Transfer of Risk

Generally, a swap is a type of derivative in which counterparties to a bilateral contract agree to exchange cash flows at specified intervals for an agreed-upon amount of time.[39] There are five major swap asset classes: interest rates, credit, equities, commodities, and foreign exchange.[40] One of the earliest reported swaps was a currency, or foreign exchange, swap between I.B.M. and the World Bank in 1981.[41] In the mid-1990s, J.P. Morgan pioneered what are now considered credit default swaps in a landmark deal by selling the credit risk of a five billion dollar loan to the European Bank of Reconstruction and Development.[42]

Observers cite credit default swaps as the primary "culprit" of the 2008 financial crisis.[43] As such, credit default swaps have been the focus of recent regulatory reforms.[44] A credit default swap offers parties a method of transferring risk.[45] One party is the "protection buyer," and the other is the "protection seller."[46] The buyer pays the seller a fee to secure protection of any loss sustained by the buyer in the event of a default on the underlying "reference entity."[47] Counterparties in a credit default swap are exposed to two types of risk.[48] One is the risk of the change in value of the underlying reference entity

39. *See id.*

40. *Asset Classes*, INT'L SWAPS & DERIVATIVES ASS'N, INC., http://www2.isda.org/asset-classes/ (last visited Jan. 30, 2016).

41. John Lanchester, *Outsmarted*, NEW YORKER (Jun. 1, 2009), http://www.newyorker.com/magazine/2009/06/01/ (explaining that the swap "allowed I.B.M. to trade surplus Swiss francs and Deutsche marks for dollars held by the World Bank" and that it "ushered in a whole new field of finance").

42. *See id.* In 1994, Exxon, a long-time client of J.P. Morgan, applied for a $5 billion line of credit to cover potential punitive damages claims from the 1989 Exxon Valdez oil spill. *See id.* Blythe Masters, a banker with J.P. Morgan, conceptualized selling the credit risk to another bank (the European Bank of Reconstruction and Development) for a fee to free J.P. Morgan from holding a large capital reserve against the risk of the loan. *See id.*

43. *See, e.g.*, Adam Davidson, *How AIG Fell Apart*, REUTERS (Sept. 18, 2008), http://www.reuters.com/article/2008/09/18/us-how-aig-fell-apart-idUSMAR85972720080918.

44. Houman B. Shadab, *Credit Default Swaps and Regulatory Reform*, MERCATUS CTR. 3 (Aug. 2009), http://mercatus.org/publication/credit-default-swaps-and-regulatory-reform (describing a reform proposal by the U.S. Treasury Department that "seeks to increase the stability and transparency of the CDS market").

45. *See* Griffith, *supra* note 26, at 1298–99 (explaining that a swap transfers the risk of fluctuating interest rates from one party to another because the parties predetermine which party pays the other when interest rates rise or fall).

46. *See id.* at 1299.

47. *See id.*

48. *See id.* at 1300. Generally, all swaps, not just credit default swaps, are subject to this type of risk. *See* COFFEE, JR. & SALE, *supra* note 36, at 25 (stating that "because trading in swaps is conducted with a counterparty, rather than a centralized market, each participant faces a credit risk as well as a market risk").

or asset causing one party to make payments to the other.[49] The other risk is the possibility of a counterparty not performing under the contract and thus being unable to make payments.[50] In the case of non-performance, the party that sought to transfer the risk is now the principle bearer.[51]

D. History of Derivatives Regulation in the United States

1. Early Attempts and Constitutional Challenges to Federal Regulation

In June 1864, Congress first attempted to regulate derivatives[52] with an act to prohibit gold futures trading.[53] The regulation, however, was short-lived and repealed two weeks later after Congress concluded the Act precipitated a sharp drop in the value of currency.[54] Congress would not pass additional regulation until August 1921 when it enacted The Future Trading Act.[55] This regulation, again, would be short lived, but not due to any perceived unintended consequences; rather as a result of a successful constitutional challenge brought by members of the Chicago Board of Trade.[56] The Supreme Court held that the grain futures contracts at issue concerned solely matters of intrastate commerce, and Congress had therefore overstepped its bounds by attempting to regulate commerce that was not interstate.[57]

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49. *See* Griffith, *supra* note 26, at 1300.

50. *See id.*

51. *See id.*

52. *See generally*, Jeremy Gogel, *"Shifting Risk to the Dumbest Guy in the Room"—Derivatives Regulation After the Wall Street Reform and Consumer Protection Act*, 11 J. BUS. & SEC. L. 1, 13 (2010) (providing a history of derivatives regulation, including the Anti-Gold Futures Act, Congress's first attempt to regulate transactions involving gold, which came about due to the perception that the lack of private market regulation resulted in the wide discrepancy between gold and "greenbacks" trading).

53. Ch. 127, 13 Stat. 132 (1864) (repealed 1864). Alan Greenspan remarked at a conference in 1997 that the Act was passed in response to the significant discount at which the Union's fiat currency—known as the greenback—was trading relative to gold. Alan Greenspan, Chairman of the Fed. Reserve Bd., Remarks at the Financial Markets Conference of the Federal Reserve Bank of Atlanta: Government Regulation and Derivative Contracts (Feb. 21, 1997) (transcript available at http://www.federalreserve.gov/BoardDocs/Speeches/1997/19970221.htm) [hereinafter Greenspan].

54. Ch. 209, 13 Stat. 132 (1864); *see also* Greenspan, *supra* note 53.

55. Future Trading Act, ch. 86, 42 Stat. 187 (1921), *invalidated by* Hill v. Wallace, 259 U.S. 44, 68–70 (1922).

56. *See Hill*, 259 U.S. at 68–70 (holding that the Act was an unconstitutional exercise of Congress's taxing power and the grain futures contracts at issue were matters of intrastate commerce). Chief Justice William Howard Taft, writing for the majority, stated that "sales for future delivery on the Board of Trade are not in and of themselves interstate commerce. They cannot come within the regulatory power of Congress as such, unless they are regarded by Congress . . . as directly interfering with interstate commerce . . . ." *Id.* at 69.

57. *Id.* at 69–70.

Shortly after the Supreme Court invalidated the Future Trading Act, Congress reacted by passing the Grain Futures Act in September 1922.[58] Guided by its recent defeat in court, Congress stated that the purpose of the Act was "[f]or the prevention and removal of obstructions and burdens upon interstate commerce in grain, by regulating transactions on grain futures exchanges."[59] The 1922 Act was challenged similarly as unconstitutional.[60] The Court, however, upheld the Grain Futures Act stating:

> In the act we are considering, Congress has expressly declared that transactions and prices of grain in dealing in futures are susceptible to speculation, manipulation, and control which are detrimental to the producer and consumer and persons handling grain in interstate commerce and render regulation imperative for the protection of such commerce and the national public interest therein.[61]

The Grain Futures Act of 1922 created and vested implementation authority in a commission within the Department of Agriculture.[62] In effect, the Grain Futures Act laid the regulatory foundation for current derivatives regulation and the modern-day Commodity Futures Trading Commission.[63]

In June 1936, Congress sought to further expand oversight and regulation by amending and renaming the Grain Futures Act of 1922 to the Commodity Exchange Act.[64] The Commodity Exchange Act (CEA) of 1936 imposed several new regulations on brokers, market participants, and exchanges.[65] One of the CEA's hallmark requirements was that all futures contracts be traded on a regulated exchange.[66] The CEA, further, extended jurisdiction to regulate not only grain futures, but also futures on other agricultural commodities.[67] While the Securities Act of 1933 and Securities Exchange Act of 1934, at the time

58. *See* Grain Futures Act, ch. 369, 42 Stat. 998 (1922).

59. *Id.*

60. *See* Bd. of Trade of Chi. v. Olsen, 262 U.S. 1, 32–33 (1923).

61. *Id.* at 37. The Court also noted that "[t]he Grain Futures Act which is now before us differs from the Future Trading Act in having the very features the absence of which we held . . . prevented our sustaining the Future Trading Act." *Id.* at 32.

62. Grain Futures Act, ch. 369, 42 Stat. 998.

63. *See* Greenspan, *supra* note 53 (noting that the Grain Futures Act created a regulatory framework for derivatives as it "made it unlawful to trade futures on exchanges other than those designated as contract markets by the Secretary of Agriculture").

64. Commodity Exchange Act, Pub. L. No. 673, ch. 545, 49 Stat. 1491 (1936).

65. *See* Gogel, *supra* note 52, at 18–19.

66. *See* Michael Greenberger, *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by an Unregulated Multi-Trillion Dollar Derivatives Market*, 6 J. BUS. & TECH. L. 127, 129–30 (2011); *see also* 7 U.S.C. § 6(a) (2012).

67. *See* Gogel, *supra* note 52, at 19; *see also* Commodity Exchange Act, 7 U.S.C. § 2 (1940) (defining "commodity" to include, among other things, "cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs . . . and soybean meal").

recently enacted, did not regulate derivatives,[68] the framework of the CEA was substantially similar to securities markets regulation.[69]

2. Expansion of Futures Markets To Include Financial Interests

By 1974, several shadow futures markets emerged that were trading unregulated commodities such as coffee, sugar, cocoa, various metals, and foreign currencies.[70] At the time, there was some indication that futures markets would soon expand into goods and services, including home mortgages.[71] Congress responded by significantly amending the CEA to further expand its regulatory jurisdiction to include futures contracts of non-agricultural commodities.[72] The definition of commodity was once again expanded to include not only specified agricultural products, but also "all other 'goods and articles . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.'"[73]

In 1974, moreover, the value of futures trading reached the approximate value of securities trading—almost $500 billion annually.[74] To oversee this vast and rapidly growing market, Congress established a new, independent regulatory agency—the Commodity Futures Trading Commission (CFTC).[75] In doing so, Congress removed the authority of the commodity exchange agency previously within the Department of Agriculture and instead vested the CFTC with "exclusive jurisdiction over financial futures and options on certain financial interests," including newly developed stock index futures.[76] The 1974 amendments to the CEA, Alan Greenspan observed, were "[i]n one respect . . . sweeping deregulation, in that it explicitly allowed the trading on futures

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68. *See* David B. Esau, *Joint Regulation of Single Stock Futures: Cause or Result of Regulatory Arbitrage and Interagency Turf Wars?*, 51 CATH. U. L. REV. 917, 919–20 (2002) (noting that the Securities Act of 1933 focused on information disclosure as the "first step in this process" and that the Securities Exchange Act of 1934 focused on regulating other securities such as stock exchanges).

69. *See* Greenberger, *supra* note 66, at 131 (explaining that "futures contracts were required to be traded on publicly transparent and fully regulated exchanges supported by clearing mechanisms that ensured that contractual commitments would be backed by adequate capital").

70. *See* HAMILTON ET AL., *supra* note 20, at 14.

71. *See id.* at 15.

72. *See* Gogel, *supra* note 52, at 22 (citing Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, § 201, 88 Stat. 1389 (1974)).

73. EDWARD F. GREEN ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 12.08 (11th ed. 2015) (citing the Commodity Exchange Act of 1974, Pub. L. No. 93-463, § 9(b)–(c), 88 Stat. 1389 (1974) (codified at 7 U.S.C. § 2 (1976)).

74. *See* HAMILTON ET AL., *supra* note 20, at 15.

75. *See* GREEN ET AL., *supra* note 73 (referencing 7 U.S.C. § 4a (1976) (addressing the establishment of the Commodity Futures Trading Commission)).

76. *See id.*; *see also* Gogel, *supra* note 52, at 22 (citing the Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389 (1974) (previously codified at 7 U.S.C. § 4(a) (1976)).

exchanges of contracts on virtually any underlying assets, including financial instruments."[77]

The 1974 amendments to the CEA also included the so-called "Treasury Amendment," which excluded foreign currencies and certain specified financial instruments (including government securities or mortgages and mortgage purchase commitments) from the jurisdiction of the CFTC if they were traded off-exchange.[78] The apparent rationale behind the Treasury Amendment was that market participants engaging in this kind of activity were most likely to be banks and other financial institutions and therefore did not need the protection of the CEA.[79] However, the Treasury Amendment failed to anticipate and protect subsequent innovative derivative contracts such as swaps.[80] What resulted was legal uncertainty about whether certain privately negotiated derivatives contracts were illegally traded off-exchange since they did not fit the definition of contracts specified in the Treasury Amendment.[81]

3. Jurisdictional Conflict over Security Futures and Subsequent Regulation Designed To Provide Legal Certainty

Following the 1974 amendments to the CEA, the Securities and Exchange Commission, disputing the breadth of the CFTC's exclusive jurisdiction, claimed certain futures contracts qualified as "securities" as defined in the Securities Act of 1933 or the Securities Exchange Act of 1934.[82] The chairmen

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77. *See* Greenspan, *supra* note 53.

78. *See* GREEN ET AL., *supra* note 73. The amendments provided that:

> Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

7 U.S.C. § 2 (1976).

79. *See* Greenspan, *supra* note 53 (stating, in 1997, that there is "no reason to presume that the regulatory framework of the CEA needs to be applied to the foreign exchange markets to achieve the public policy objectives that motivated the CEA"); *but see* Chad Bray et al., *Big Banks Are Fined $4.25 Billion in Inquiry into Currency-Rigging*, N.Y TIMES (Nov. 12, 2014, 2:24 AM), http://dealbook.nytimes.com/2014/11/12/british-and-u-s-regulators-fine-big-banks-3-16-billion-in-foreign-exchange-scandal/?_r=0 (detailing a massive foreign exchange rate fixing scandal among traders at the world's largest banks).

80. *See* Greenspan, *supra* note 53. The International Swaps and Derivatives Association defines a "swap" as "a bilateral agreement to exchange cash flows at specified intervals (payment dates) during the agreed-upon life of the transaction." *Product Descriptions and Frequently Asked Questions*, INT'L SWAPS & DERIVATIVES ASSOC., http://www.isda.org/educat/faqs.html#10 (last visited Oct. 9, 2015).

81. *See* Greenspan, *supra* note 53; *see also* GREEN ET AL, *supra* note 73, at § 12.09, n.183.

82. GREEN ET AL., *supra* note 73, at § 12.09; *see, e.g.*, SEC v. Univest, Inc., 410 F.Supp. 1029, 1030–31 (N.D. Ill. 1976) (holding that promissory notes issued by the company to customers in an effort to liquidate its business debts were not "securities" within the meaning of the federal security laws, but rather "agreements" within the meaning of Section 2 of the CEA, and therefore subject to the CFTC's exclusive jurisdiction).

of the CFTC and SEC met in 1981 to discuss their respective positions on jurisdiction and reached an agreement known as the Shad-Johnson Accord.[83] The Accord established that the SEC retained exclusive jurisdiction over security-based options contracts, and the CFTC retained exclusive jurisdiction over options on all commodities that were not securities and futures contracts on broad-based security indices.[84] The Accord also established a prohibition on futures contracts and options on futures contracts of a single security or a narrow-based security index (i.e., neither the CFTC nor SEC were granted authority to authorize such contracts to trade).[85]

The Accord failed, however, to completely settle the disputes between the CFTC and SEC.[86] As innovative derivative contracts exhibiting characteristics of both a security and a futures contract increased prevalence in the market, the jurisdictional battle returned.[87] One such product is the interest rate swap. Similar to a traditional futures contract—where the buyer and seller agree to a fixed price (payable at present) of a future rate—an interest rate swap is essentially a "'swapping' of commitments, with one party buying the fixed rate and selling the floating rate, while the other party is buying the floating rate and selling the fixed rate."[88] The CFTC, recognizing that swaps, like futures contracts, might be subject to the mandatory exchange-trading requirement of the CEA, issued a policy statement in 1989 exempting swaps from the requirement.[89] However, the CEA did not permit or otherwise authorize the CFTC to issue such an exemption.[90] As such, Congress enacted the Futures Trading Practices Act of 1992 to legitimize the CFTC's actions and provide greater legal certainty regarding swaps.[91]

While the Futures Trading Practices Act of 1992 did not resolve the ongoing jurisdictional issues between the CFTC and SEC, it did provide practical relief

83. *See* Pub. L. No. 97-303, 96 Stat. 1409 (1982) (codified at 15 U.S.C. §§ 77–78 (1988)) (clarifying the jurisdiction of the SEC and the definition of security); *see also* Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (1983) (codified at 7 U.S.C. §§ 1–26 (1988); U.S. GEN. ACCOUNTING OFFICE, REPORT TO CONGRESSIONAL REQUESTERS, ISSUES RELATED TO THE SHAD-JOHNSON JURISDICTIONAL ACCORD 5–6 (2000), http://www.gao.gov/archive/2000/gg00089.pdf.

84. *See* Esau, *supra* note 68, at 921–22; *see also* GREEN ET AL., *supra* note 73, at § 12.09.

85. *See* GREEN ET AL., *supra* note 73, at § 12.09.

86. *See id.* at § 12.10; *see also* Chi. Mercantile Exch. v. SEC, 883 F.2d 537, 549–50 (7th Cir. 1989) (opining that certain stock exchange index participation contracts more convincingly appear to be futures contracts more convincingly than the secondary appearance of options on securities, and are therefore subject to the jurisdiction of the CFTC).

87. *See* GREEN ET AL., *supra* note 73, at § 12.10.

88. Greenberger, *supra* note 66, at 132.

89. *See id.* at 133; *see also* Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694, 30,694 (July 21, 1989).

90. *See* GREEN ET AL., *supra* note 73, at § 12.10; Greenberger, *supra* note 66, at 133.

91. Greenberger, *supra* note 66, at 133–34 (citing Futures Trading Practices Act of 1992, Pub. L. No. 102-546, § 502, 106 Stat. 3590 (1992) (codified in scattered sections of 7 U.S.C.)); *see also* GREEN ET AL., *supra* note 73, at § 12.10.

to the market by vesting in the CFTC the authority to exempt a broad range of novel derivative instruments from the exchange-trading requirement.[92] Congress further allayed any concern that remained from the 1989 CEA policy statement by passing the Futures Trading Practices Act.[93] Pursuant to its new authority, the CFTC officially exempted swaps from regulation in 1993.[94]

Rapid growth followed in the OTC derivatives market.[95] Subsequently, however, so did a number of large financial losses.[96] For example, the largest municipal default in U.S. history occurred in 1994 when Orange County, California executives entered into interest rate swap transactions without understanding the risk or consequences in the event interest rates were to rise quickly (which is exactly what happened).[97] The county lost approximately $1.6 billion and filed for bankruptcy.[98] In the same year, two large corporations, Gibson Greetings and Procter & Gamble, both clients of Bankers Trust, sued the bank after the corporations lost significant amounts of money based on their purchase of unregulated derivative products from the bank.[99]

The high-profile losses from unregulated derivative transactions prompted the CFTC to promulgate a concept release in May 1998, calling into question whether OTC derivatives should indeed be subject to the mandatory exchange-trading requirement of the CEA.[100] The CFTC found that most swap transactions had become highly standardized and were being traded multilaterally, thus subverting the intent of the safe harbor exemption for swaps.[101] The 1998 concept release prompted an immediate joint press release from the Department of the Treasury, the Federal Reserve Board, and the SEC, calling into doubt the scope of the CFTC's jurisdiction.[102]

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92. *See* GREEN ET AL., *supra* note 73, at § 12.11.

93. Greenberger, *supra* note 66, at 133.

94. *See* GREEN ET AL., *supra* note 73, at § 12.11(1).

95. *See* Eli M. Remolona, *The Recent Growth of Financial Derivative Markets*, 17 FED. RES. BANK N.Y. Q. REV. 28, 30 (1992), https://www.newyorkfed.org/medialibrary/media/research/quarterly_review/1992v17/v17n4article2.pdf (stating that "[i]nterest rate swaps, the dominant OTC derivative from the outset, grew an average of 41 percent a year in notional principal from 1986 to 1991 and alone accounted for possibly half of the absolute increase in total notional principal of all OTC derivatives during the period").

96. *See* Greenberger, *supra* note 66, at 137 (citing Over-the-Counter Derivatives, 63 Fed. Reg. 26,114, 26,115 (May 12, 1998)).

97. *Id.* at 137–38.

98. *Id.*

99. *Id.* at 138.

100. *Id.* at 136.

101. *Id.; see also* 63 Fed. Reg. at 26,116 (explaining that "[t]o qualify for a safe harbor from regulation . . . a swap agreement must have [among other things] individually tailored terms").

102. Press Release, Joint Statement by Robert E. Rubin, Treasury Secretary, Alan Greenspan, Federal Reserve Board Chairman, & Arthur Levitt, Chairman of the SEC (May 7, 1998), http://www.treasury.gov/press-center/press-releases/Pages/rr2426.aspx (stating that "[w]e seriously question the scope of the CFTC's jurisdiction in this area, and we are very concerned about reports

In September 1998, just months after the publication of the concept release, Long Term Capital Management, one of the largest and most successful hedge funds at the time, nearly collapsed from losses sustained in OTC derivative positions.[103] Despite evidence that unregulated OTC derivatives were extremely risky products that even sophisticated investors misunderstood, Congress, seemingly influenced by senior officials at the Treasury Department, the SEC, and the Federal Reserve Board, was more concerned with promoting innovation and competition in the market and sought to formally keep those transactions off-exchange and in the dark.[104]

In 1999, the President's Working Group on Financial Markets submitted a report to Congress recommending that OTC derivatives be completely deregulated.[105] The cover letter to the report explained the Working Group's reasoning for the recommendation, saying, "[a] cloud of legal uncertainty has hung over the OTC derivatives markets in the United States in recent years, which, if not addressed, could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore."[106] It did not take long for Congress to react.

4. The Commodity Futures Modernization Act of 2000 Excludes OTC Derivatives from Substantive Regulation

Congress, persuaded by the Working Group's recommendation, passed the Commodity Futures Modernization Act of 2000 (CFMA).[107] The CFMA amended the CEA to exclude OTC derivatives from substantive regulation by exempting "any agreement, contract or transaction that (i) involved a nonagricultural commodity, (ii) was entered into solely between [eligible

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that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives").

103. *See* Greenberger, *supra* note 66, at 139; *see also* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS 12–14 (1999), https://www.treasury.gov/resource-center/fin-mkts/Documents/otcact.pdf.

104. *See* Omnibus Consolidated and Emergency Supplemental Appropriations Act, Pub. L. No. 105-277, § 760, 112 Stat. 2681 (1998) (enacting standstill legislation prohibiting the CFTC from issuing any rule, regulation, interpretation, or policy statement that would restrict or regulate swaps activity); *see also* Wilmarth, Jr., *supra* note 9, at 1420–24 (discussing views held by senior government regulators in the 1990s to 2000s that minimized governmental interference to promote innovation and competition in financial markets).

105. *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS 15–16, *supra* note 103 (stating that "[t]he members of the Working Group agree that there is no compelling evidence of problems involving bilateral swap agreements that would warrant regulation under the CEA").

106. *Id.*

107. Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 1–27(f) (2012); *see also supra* text accompanying notes 105–06 (explaining the findings of the President's Working Group on Financial Markets, as submitted to Congress).

contract participants,[108]] and (iii) was not entered into or executed on a 'trading facility.'"[109] Further, the CFMA enabled certain qualifying OTC derivatives transactions to be cleared[110] by a clearing organization[111] to ensure their "eligibility for exclusion or exemption from CEA regulation."[112] Finally, the CFMA lifted the ban on trading futures contracts on single securities and narrow-based security indices established by the Shad-Johnson Accord.[113]

Due to the deregulatory effect of the CFMA, OTC derivatives were not sufficiently monitored during the run-up to the financial crisis in 2008.[114] Regulators were stripped of their ability to monitor systemic risk or implement appropriate prophylactic measures.[115] Christopher Cox, former chairman of the SEC, noted in October 2008 that the OTC derivatives market (in particular, credit default swaps) had become a "regulatory black hole."[116]

5. The Global Financial Crisis and Subsequent Regulatory Overhaul

The events of 2008 and the resulting fallout can best be described as a culmination of a financial perfect storm. Deregulation to foster financial innovation and promote competitiveness in an increasingly global marketplace, coupled with lax lending standards to promote homeownership, led the United

108. *See* GREEN ET AL., *supra* note 73, at § 12.13(1); *see also* 7 U.S.C. § 1a(12) (2006) (defining an "eligible contract participant"). Generally, an "eligible contract participant" is "[a]n entity, such as a financial institution, an insurance company, or commodity pool, that is classified by the CEA . . . based upon its regulated status or the amount it invests on a discretionary basis." *CFTC Glossary*, COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm (last visited Jan. 30, 2016).

109. GREEN ET AL., *supra* note 73, at § 12.13(1); *see also* 7 U.S.C. § 1a(33)(A) (defining "trading facility" as "a person or group of persons that constitutes, maintains, or provides a physical or electronic facility or system in which multiple participants have the ability to execute or trade agreements, contracts, or transactions by accepting bids and offers made by other participants that are open to multiple participants in the facility or system").

110. "Clearing" is "[t]he procedure through which the clearing organization becomes the buyer to each seller of a futures contract or other derivative, and the seller to each buyer for clearing members." *CFTC Glossary*, *supra* note 108.

111. *See* 7 U.S.C. § 1a(9) (2012). A "clearing organization" is "[a]n entity through which futures and other derivative transactions are cleared and settled." *CFTC Glossary*, *supra* note 108. "It is also charged with assuring the proper conduct of each contract's delivery procedures and the adequate financing of trading." *Id.*

112. GREEN ET AL., *supra* note 73, at § 12.13(1).

113. *See* Gogel, *supra* note 52, at 27.

114. *See* THE FIN. CRISIS INQUIRY COMM'N, *supra* note 4, at 48–49.

115. *See id.* at 48 (stating that "[t]he CFMA effectively shielded OTC derivatives from virtually all regulation or oversight").

116. Christopher Cox, Chairman of the SEC, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008), http://www.sec.gov/news/speech/2008/spch100808cc.htm (noting that the credit default swap market "has grown between the gaps and seams of the current regulatory system, where neither the [SEC] nor any other government agency can reach it").

States to experience its worst financial crisis since the Great Depression.[117] The collapse of Lehman Brothers and the subsequent bailout of AIG were like an earthquake that rocked the financial landscape, the aftershocks of which were felt around the world.[118] Due to the globalization of the derivatives markets in the 2000s, the effects of the 2008 economic collapse—unlike the financial crisis of the 1990s[119]—finally convinced Congress of the need for proper regulation of OTC derivatives.[120]

In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Dodd-Frank"), which effectively repealed much of the CFMA.[121] In stark contrast to a decades-long "light touch" approach,[122] OTC derivatives were finally subject to much of the same regulation that existed for other financial products and securities traded on regulated exchanges.[123]

First, Dodd-Frank defines and distinguishes between "swaps" and "security-based swaps."[124] The CFTC retains jurisdiction over swaps, and the SEC regulates security-based swaps.[125] To the extent any product exhibits features of both a swap and a security-based swap (i.e., a "mixed swap"[126]), it will be regulated jointly by the CFTC and the SEC.[127] Dodd-Frank further imposes similar requirements on both swaps and security-based swaps, including, among

117. *See* THE FIN. CRISIS INQUIRY COMM'N, *supra* note 4, at xv, 443 (describing the 2008 financial crisis as "the greatest financial crisis since the Great Depression").

118. *See* Susanne Craig et al., *AIG, Lehman Shock Hits World Markets*, WALL. ST. J. (Sept. 16, 2008, 11:59 PM), http://online.wsj.com/articles/SB122152314746339697 (stating that "the convulsions in the U.S. financial system sent markets across the globe tumbling").

119. *See Two Financial Crises Compared: The Savings and Loan Debacle and the Mortgage Mess*, N.Y. TIMES (Apr. 13, 2011), http://www.nytimes.com/interactive/2011/04/14/business/20110414-prosecute.html (comparing the U.S. government's responses to the savings and loan crisis and the 2008 financial crisis); *supra* notes 97–113 and accompanying text.

120. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5301 (2012) (stating the purpose of the Act is "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system"); *see also Derivatives*, SEC, http://www.sec.gov/spotlight/dodd-frank/derivatives.shtml (last visited Nov. 25, 2014) (explaining that "Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act addresses the gap in U.S. financial regulation of OTC swaps by providing a comprehensive framework for the regulation of the OTC swaps markets").

121. Pub. L. No. 111-203, 124 Stat. 1376 (2012) (to be codified in scattered sections of the U.S. Code); *see also Derivatives*, *supra* note 120.

122. *See* Wilmarth, Jr., *supra* note 9, at 1393.

123. *See* Marc A. Horwitz, *Dodd-Frank Act Aims To Fundamentally Change Trading of OTC Derivatives*, DLA PIPER (Jul. 26, 2010), http://www.dlapiper.com/en/us/insights/publications/2010/07/doddfrank-act-aims-to-fundamentally-change-tradi__/ (stating that the Dodd-Frank Act "contains a sweeping overhaul of the regulation of over-the-counter derivatives markets").

124. *See* § 761, 124 Stat. at 1756 (codified as amended at 15 U.S.C. § 78c (2012)).

125. § 712, 124 Stat. at 1641 (codified as amended at 15 U.S.C. § 8302 (2012)).

126. *Id.* at 1642.

127. *Id.*

other things, registration of dealers and major participants, exchange trading, clearing, and trade reporting.[128]

a. Extraterritorial Jurisdiction

Considering the global nature of the OTC derivatives market, Congress specifically contemplated that certain provisions of Dodd-Frank may need to apply to foreign counterparties in cross-border transactions.[129] The applicable statutory provisions provide that if there is a "direct and significant connection with activities in, or effect on, commerce of the United States,"[130] or if a person transacting business in swaps or securities-based swaps acts in contravention of rules or regulations promulgated by the CFTC or the SEC designed to prevent evasion of Dodd-Frank, such person or transaction will come under the jurisdiction of U.S. law.[131] Congress also provided explicit authority for the Commissions to consult and coordinate with foreign regulators to implement consistency in global derivatives regulation.[132]

The language in Dodd-Frank addressing the extraterritorial jurisdiction of the SEC was the direct result of the Supreme Court's decision in *Morrison v. National Australia Bank Ltd.*[133] In *Morrison*, the Court announced that the Exchange Act did not "reach[] conduct in this country affecting exchanges or transactions abroad,"[134] and the antifraud provisions applied "only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."[135]

Commissioner Kara Stein noted at the open commission meeting adopting some of the SEC's cross-border rules that "Section 929P of the Dodd-Frank Act explicitly grants the Commission the power to protect American markets and people" and "was enacted just days after the *Morrison* decision."[136] The relevant statute states:

> (c) EXTRATERRITORIAL JURISDICTION.—The district courts of the United States and the United States courts of any Territory shall have jurisdiction of an action or proceeding brought or instituted by

128. *Id.* at 1641–42 (noting that the SEC and the CFTC are required to regulate swaps and security-based swaps in the same manner).

129. *See* § 929P, 124 Stat. at 1864 (codified as amended at 15 U.S.C. § 77v (2012)).

130. § 722(d), 124 Stat. at 1673 (codified as amended at 7 U.S.C. § 2 (2012)).

131. *See* § 772, 124 Stat. at 1802.

132. *See* § 752, 124 Stat. at 1749–50.

133. 561 U.S. 247, 267–68 (2010); *see also* Richard W. Painter, *The Dodd-Frank Extraterritorial Jurisdiction Provision: Was It Effective, Needed or Sufficient?*, 1 HARV. BUS. L. J. 195, 199 (2011) (explaining that "Congress responded to *Morrison* with statutory language directed at cases brought by the SEC and DOJ").

134. *Morrison*, 561 U.S. at 269.

135. *Id.* at 273.

136. Press Release, Kara M. Stein, Commissioner, SEC, Cross-Border Security-Based Swap Rules and Guidance (June 25, 2014), http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542555426.

> the Commission or the United States alleging a violation of Section 17(a) involving—
>
> > (1) conduct within the United States that constitutes significant steps in furtherance of the violation, even if the securities transaction occurs outside the United States and involves only foreign investors; or
> >
> > (2) conduct occurring outside the United States that has a foreseeable substantial effect within the United States.[137]

b. Substituted Compliance and Equivalence

One of the most innovative aspects of Dodd-Frank is its adoption of a regulatory approach allowing certain market participants to substitute compliance with a foreign jurisdiction's regulatory regime in place of Dodd-Frank.[138] The CFTC and SEC have issued guidance and proposed rulemaking that outlines their respective approaches to implementing a substituted compliance framework.[139] Similarly, in the European Union, the European Securities Markets Authority (ESMA) has proposed a framework for issuing "equivalence" determinations for third-countries as a way to substitute compliance with European Market Infrastructure Regulation.[140]

i. CFTC Final Guidance

The CFTC issued its final interpretive guidance and policy statement outlining its process for substituted compliance determinations on July 26, 2013.[141] The CFTC stated that it seeks to achieve an "outcomes-based" approach by reviewing the foreign jurisdiction's rules for comparability to Dodd-Frank, but it does not require a foreign jurisdiction's rules to be identical.[142] In issuing a comparability determination, the CFTC states it

> will take into consideration all relevant factors, including but not limited to, the comprehensiveness of [the foreign jurisdiction's] requirement(s), the scope and objectives of the relevant regulatory requirement(s), the comprehensiveness of the foreign regulator's

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137. § 929P, 124 Stat. at 1864.

138. *See* Cross-Border Security-Based Swap Activities, 78 Fed. Reg. 31,085 (May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, and 249).

139. *See* Interpretive Guidance, 78 Fed. Reg. 45,292, 45,340–46 (July 26, 2013) (to be codified at 17 C.F.R. ch. 1); *see also Cross-Border Security-Based Swap Activities*, 78 Fed. Reg. at 31,085–101.

140. *See* EUR. SEC. & MKT. AUTH., ESMA DELIVERS SECOND SET OF ADVICE ON EMIR EQUIVALENCE (Feb. 10, 2013), http://www.esma.europa.eu/news/ESMA-delivers-second-set-advice-EMIR-equivalence.

141. *See* Interpretive Guidance, 78 Fed. Reg. at 45,340.

142. *Id.* at 45,342–43.

> supervisory compliance program, as well as the home jurisdiction's authority to support and enforce its oversight of the registrant.[143]

The comparability analysis will be based on comparison of thirteen categories: five "entity-level" and eight "transaction-level" requirements.[144] On December 20, 2013, the CFTC approved comparability determinations for six jurisdictions.[145] The CFTC worked with authorities and market participants in each jurisdiction to issue the determinations.[146] Australia, Canada, the European Union, Hong Kong, Japan, and Switzerland were deemed comparable with respect to certain entity-level requirements.[147] Additionally, the EU and Japan were deemed comparable for certain transaction-level requirements.[148]

ii. The SEC's Proposed Cross-Border Rules

The SEC's approach to issuing comparability determinations for substituted compliance is similar to the CFTC's approach.[149] The SEC proposed a rule that would allow international market participants "engaged in conduct that the statutory provision regulates" the ability to comply with the SEC's security-based swap rules through "substituted compliance," a concept wherein satisfaction of foreign law the SEC has deemed to be comparable to the SEC's security-based swap rules complies with U.S. regulations.[150] According to the

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143. *Id.* at 45,343.

144. *Id.* at 45,344.

145. Press Release, U.S. Commodity Futures Trading Comm'n, CFTC Approves Comparability Determinations for Six Jurisdictions for Substituted Compliance Purposes (Dec. 20, 2013), http://www.cftc.gov/PressRoom/PressReleases/pr6802-13.

146. *Id.*

147. *Id.*

148. *Id.*

149. *See* Cross-Border Security-Based Swap Activities, 78 Fed. Reg. at 30,975 (characterizing the SEC's proposed approach as "focus[ed] on regulatory outcomes rather than a rule-by-rule comparison"); *see also supra* notes 145–46 and accompany text.

150. *See* Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, Release No. 34-72472, 79 Fed. Reg. 39,067, 39,147 (July 9, 2014) (to be codified at 17 C.F.R. pts. 240, 241, and 250); DAVIS, POLK & WARDWELL, CLIENT MEMORANDUM, SEC ADOPTS SECURITY-BASED SWAP CROSS-BORDER DEFINITION RULE 5 (July 3, 2014), http://www.davispolk.com/sites/default/files/07.03.14.SEC_.Adopts.Security.Based_.Swap_.Cross_.Border.Definitional.Rule_.pdf. However, "[t]he SEC did not address in the new rule the provisions from the proposed rule defining when substituted compliance may be used, but provides a process through which market participants and foreign regulators will be able to petition the SEC for a substituted compliance order." DAVIS, POLK & WARDWELL, *supra*, at 5. Nevertheless, "[t]he SEC plans to adopt provisions regarding the situations in which substituted compliance may be used for each substantive Title VII rule as part of each relevant substantive rule." *Id.* Since the SEC has not yet adopted every proposed rule, it has not yet addressed every situation in which substituted compliance would be available. Application of "Security-Based Swap Dealer" and "Major Security-Based Swap Participant" Definitions to Cross-Border Security-Based Swap Activities, 79 Fed. Reg. at 39,068 ("The Commission is not addressing, as part of this release, certain other rules that we proposed regarding the application of Subtitle B of Title VII in the cross-border context.").

proposal, the SEC will look to four separate categories of requirements.[151] If the SEC determines that regulatory outcomes are comparable in three out of the four required categories, it would permit substituted compliance with those three categories.[152] The four categories to be considered by the SEC include:

> (i) Requirements applicable to registered security-based swap dealers in Section 15F of the Exchange Act and the rules and regulations thereunder; (ii) requirements relating to regulatory reporting and public dissemination of information on security-based swaps; (iii) requirements relating to clearing for security-based swaps; and (iv) requirements relating to trade execution for security-based swaps.[153]

Similar to the CFTC, the SEC states that it will take a "holistic approach" that "focus[es] on regulatory outcomes rather than a rule-by-rule comparison."[154] However, the proposal does not identify with any particularity how it will evaluate a foreign jurisdiction's regulatory regime to determine if it is comparable. For example, in making substituted compliance determinations, the SEC states it will do so

> only if we find that the requirements of such foreign financial regulatory system are comparable to otherwise applicable requirements, taking into account factors that the Commission determines appropriate, such as, for example, the scope and objectives of the relevant foreign regulatory requirements, as well as the effectiveness of the supervisory compliance program administered, and the enforcement authority exercised, by a foreign financial regulatory authority or authorities in such system to support its oversight of such foreign security-based swap dealer (or any class thereof).[155]

iii. The European Markets and Infrastructure Regulation

The European Union has taken a very similar approach to derivatives regulation. The principal legislation, the European Markets and Infrastructure Regulation (EMIR),[156] allows the European Commission, pursuant to advice from the European Markets and Securities Authority (ESMA), to issue "equivalency" determinations much like the ability of both the CFTC and the SEC to issue substituted compliance determinations.[157] ESMA, in its final report on technical advice on third country equivalence, states that the European Commission should follow an "objective-based approach, where the capability

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151. *Id.*
152. *Id.*
153. *Id.* at 31,085.
154. *Id.* at 30,975; *see supra* notes 143, 149 and accompanying text.
155. Cross-Border Security-Based Swap Activities, 78 Fed. Reg. at 30,975.
156. Regulation (EU) 648/2012, 2012 O.J. (L 201) 1 (commonly referred to as the "European Market Infrastructure Regulation" or "EMIR").
157. *Id.* at (L 201) 2.

of the regime in the third country to meet the objectives of the EU Regulation is assessed from a holistic perspective."[158] The European Commission will consider equivalence for the United States by evaluating three specific areas: (i) central counterparties,[159] (ii) trade repositories,[160] and (iii) "potentially duplicative or conflicting requirements regarding the clearing obligation, reporting obligation, non-financial counterparties and risk-mitigation techniques for OTC derivative contracts not cleared by a [central counterparty]."[161]

II. ANALYSIS OF COMPARABILITY DETERMINATIONS FOR SUBSTITUTED COMPLIANCE AND HARMONIZATION EFFORTS ON IMPLEMENTATION

Although the CFTC stated it would take an "outcomes-based" approach,[162] the comparability determinations issued by the Commission appear to take a rule-by-rule analysis. Commissioner Scott O'Malia, dissenting from the approval of the comparability determinations, stated that "[i]f the Commission's objective for substituted compliance is to develop a narrow rule-by-rule approach that leaves unanswered major regulatory gaps between our regulatory framework and foreign jurisdictions, then I believe that the Commission has successfully achieved its goal today."[163]

As discussed above, the implementing rules and legislation for OTC derivatives reform are very similar for both the United States and the European Union.[164] Despite efforts for harmonization, however, the European Union has lagged far behind the United States in addressing meaningful reform. While the European Markets Infrastructure Regulation is indeed the principal European legislation addressing clearing and reporting OTC derivatives, two more recent pieces of legislation were passed in order to meet the G20 commitments.[165] The Markets in Financial Instruments Directive II (MiFID II) addresses trading (which does not take effect until 2017),[166] and the Market Abuse Regulation

158. EUR. SEC. & MKT. AUTH., FINAL REPORT: TECHNICAL ADVICE ON THIRD COUNTRY REGULATORY EQUIVALENCE UNDER EMIR-US 5 (Sept. 1, 2013), http://www.esma.europa.eu/content/Technical-advice-third-country-regulatory-equivalence-under-EMIR-%E2%80%93-US.

159. A central counterparty may be recognized by ESMA if it complies with similarly legally binding requirements to those of EMIR, it is supervised in the third party country, and it is subject to a similar legal framework in that third party country. *See id.* at 6–7.

160. A trade repository from a third country may also be recognized by ESMA if the third country imposes a similar legal framework to EMIR. *See id.* at 7.

161. *See id.* at 6.

162. *See supra* note 142 and accompanying text.

163. Comparability Determinations, 78 Fed. Reg. 78,839, 78,851 (Dec. 27, 2013).

164. *See supra* Part I.D.5.a–b.

165. Press Release, Eur. Securities & Market Authority, ESMA Readies MiFID II, MAR and CSDR (Sept. 28, 2015), https://www.esma.europa.eu/system/files/2015-1466_press_release_-_final_mifid_ii_mar_csdr_0.pdf.

166. *Id.*

addresses manipulation of foreign exchange rates and other enforcement issues.[167]

In contrast, Dodd-Frank covers each of the G20 commitments,[168] and the CFTC largely completes its mandatory rulemakings pursuant thereunder.[169] While the SEC is working its way diligently toward completing its Dodd-Frank rulemaking requirements,[170] the Commission is also involved largely with other rulemaking determinations pursuant to the Jumpstart Our Business Startups Act of 2012.[171] If the CFTC and SEC are to make any meaningful substituted compliance determinations with respect to the European Union, it is difficult, if not impossible, to do so without any comparable legislation to consider. Accordingly, the Financial Stability Board, in its most recent progress report on OTC derivatives reforms, states that it "continues to urge [foreign] jurisdictions to promptly put in place any remaining legislation and regulation in a form flexible enough to respond to cross-border consistency."[172] Further, coordinated regulations in key areas would reduce the appeal for regulatory arbitrage.[173] Some scholars, however, argue that complete harmonization across the G20 jurisdictions to create a single global regulatory regime could increase, rather than decrease, systemic risk.[174]

III. THE CASE FOR COMPATIBLE REPORTING REQUIREMENTS AND UNIFORM GLOBAL IDENTIFIERS

While substituted compliance and equivalence are steps in the right direction in order to achieve global regulatory reform of OTC derivatives, part of the success depends on compatible reporting requirements and uniformity of data. To illustrate the need for uniform global swap trade data reporting, recall the bankruptcy of Lehman Brothers that precipitated the crisis.[175] At the time Lehman collapsed, "regulators and private sector managers were unable to assess quickly and fully the extent of market participants' exposure to Lehman and how the vast network of market participants were connected to one

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167. *Id.*

168. *See* Kubas, *supra* note 12.

169. *See* discussion *supra* Part I.D.5.b.i.

170. *See* discussion *supra* Part I.D.5.b.ii.

171. *See* Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313 (April 5, 2012) (codified at 15 U.S.C. 77d(a) (2012)).

172. FIN. STABILITY BD., *supra* note 12, at 33.

173. *See Regulatory Arbitrage*, INVESTOPEDIA, http://www.investopedia.com/terms/r/regulatory-arbitrage.asp (last visited Jan. 30, 2016) (defining "regulatory arbitrage" as "[a] practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavorable regulation").

174. *See, e.g.*, Griffith, *supra* note 26, at 1356 (stating that "uniform financial regulation can contribute to systemic risk by causing the behavior of regulated institutions to converge on similar business strategies" leading to "destructive coordination").

175. *See Legal Entity Identifier—Frequently Asked Questions*, OFF. FIN. RES., http://financialresearch.gov/data/legal-entity-identifier-faqs/ (last visited Oct. 12, 2015).

another."[176] The global financial crisis that followed "underscored the need for a global system to identify financial connections."[177]

A. Compatible Data Reporting Requirements and Uniform Global Identifiers

Regulators issuing substituted compliance or equivalency determinations should primarily focus on whether a foreign jurisdiction's swap reporting data is compatible with the regulators' existing systems. Issuing substituted compliance in swap data reporting is of great importance as it allows a swap dealer to comply with only one set of rules, thus reducing redundant or duplicative obligations. Indeed, both the United States and European Union allow for a substituted compliance or equivalency determination for swap data reporting.[178] However, to make sharing of swap transaction data meaningful, regulators worldwide should adopt the recommendation of the International Swaps and Derivatives Association and implement "internationally compatible reporting systems so that cross-border . . . swaps would not have to be reported twice."[179]

Indeed, the Financial Stability Board (FSB) identified implementation issues in trade reporting, noting "authorities continue to report . . . inconsistencies in data fields and formats across [trade repositories]."[180] However, the FSB notes that "a number of international workstreams are currently in place" and "cover a wide range of considerations including . . . standardi[z]ation of transaction and product identifiers to help support more consistency in data."[181] Continuing in the right direction, the FSB also states that it "will work with [the Committee of Payments and Market Infrastructures] and [the International Organization of Securities Commissions] to provide official sector impetus and coordination for the further development and implementation of uniform global [unique transaction identifiers] and [unique product identifiers]."[182] The FSB further advocates for, and is progressing towards, implementing a global legal entity identifier system.[183] Using global unique identifiers for transaction, product,

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176. *Id.*

177. *Id.*

178. *See* Cross-Border Security-Based Swap Activities, 78 Fed. Reg. 31,085 (May 23, 2013) (to be codified at 17 C.F.R. pts. 240, 242, and 249); Press Release, European Commission, First "Equivalence" Decisions for Central Counterparty Regulatory Regimes Adopted Today (Oct. 30, 2014), http://europa.eu/rapid/press-release_IP-14-1228_en.htm?locale=en.

179. Cross-Border Security-Based Swap Activities, 78 Fed. Reg. at 31,092.

180. FIN. STABILITY BD., *supra* note 12, at 26.

181. *Id.* at 28.

182. *Id.* The International Swaps and Derivatives Association has led the way in developing uniform data reporting standards and formats. *See Data and Reporting*, INT'L SWAPS & DERIVATIVES ASS'N, http://www2.isda.org/functional-areas/technology-infrastructure/data-and-reporting/ (last visited Oct. 5, 2015).

183. *See* FIN. STABILITY BD., *supra* note 12, at 29; *see also Legal Entity Identifier—Frequently Asked Questions*, *supra* note 175 (explaining that an LEI is "a reference code . . . to uniquely identify a legally distinct entity that engages in a financial transaction").

and legal entity reporting will provide for valuable risk management and assist in responding to weaknesses in the global financial system.

IV. CONCLUSION

The previously unregulated OTC derivatives market has undergone vast reforms since the global financial crisis of 2008. A global coordinated effort is necessary to achieve meaningful regulatory reform. The United States and European Union, in seeking to make substituted compliance and equivalency determinations, should focus on creating a uniform data format in swap data sharing. An internationally compatible reporting system and adoption of global swap data identifiers, such as the unique identifiers promoted by the Financial Stability Board,[184] should be implemented to allow regulators to monitor and evaluate global systemic risk. To the extent possible, regulators should seek to harmonize their approaches and timelines to achieving OTC derivatives regulatory reform in an effort to reduce regulatory arbitrage.

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184. *See generally* FIN. STABILITY BD., *supra* note 12.