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Investing and Pretending

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Investing and Pretending

Anita K. Krug*

ABSTRACT: One of the more prominent components of Dodd–Frank’s regulatory changes was Title VII, providing for the regulation of the over-the-counter derivatives known as “swaps.” A swap is a financial instrument whose value is based on an asset—the “reference asset”—that is wholly unrelated to the swap itself. Although there was much ado about swap regulation immediately after Dodd–Frank’s enactment, the same cannot be said of the many rules that the Commodity Futures Trading Commission (“CFTC”) has subsequently adopted pursuant to its authority under Title VII.

This Article critically evaluates the CFTC’s “swap rules” and identifies the regulatory vision that they reflect. Based on that evaluation, it argues that the swap rules are grounded in a notable distinction between swaps and another financial market instrument—namely, securities. In particular, whereas “investing” is the hallmark of securities transactions, swap transactions fall under the rubric of “pretending,” a concept that this Article employs to elucidate the function and structure of swaps. Each party to a swap pretends that it holds either a long position or a short position in the reference asset, making payments to (or receiving payments from) the other party based on the performance of that position.

Although the distinction between investing and pretending is vividly reflected in the CFTC’s approach to crafting the swap rules, this Article contends that the distinction is irrelevant for regulatory purposes. Moreover, the substantial regulatory costs arising from the CFTC’s pretense-based approach to swap regulation are likely to excessively hinder swap use, as firms seeking to mitigate risk turn to other types of hedging strategies in situations in which using swaps might otherwise be more socially beneficial. With the goal of efficient and coherent regulation in mind, this Article proposes that a substantially better approach to the CFTC’s swap rules would be to predicate them not on pretending, as the counterpoint to investing but, rather, on

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something that swap transactions and securities transactions have in common—and on which securities regulation, too, is based: the risks arising from speculation.

I. INTRODUCTION	1560
II. THE DERIVATIVES KNOWN AS SWAPS.....	1566
A. SWAPS.....	1568
1. Their Nature.....	1568
2. Their Purpose.....	1571
B. SWAPS AND THE FINANCIAL CRISIS	1573
C. CHALLENGE TO REGULATION.....	1577
D. TITLE VII OF DODD–FRANK	1581
III. THE SWAP RULES	1587
A. THE SWAP DEALER RULES	1588
B. THE CROSS-BORDER RULES.....	1596
1. Regulatory Approach.....	1597
2. U.S. Person Definition.....	1599
3. Extraterritorial Application.....	1602
IV. RETHINKING SWAP REGULATION’S FOUNDATIONS	1605
A. PRETENDING V. INVESTING.....	1605
B. SPECULATION.....	1610
V. CONCLUSION	1617

I. INTRODUCTION

Although it may seem as though the financial crisis was only yesterday, it began almost seven years ago, and Congress finalized the statute intended to prevent its recurrence, the Dodd–Frank Act of 2010 (“Dodd–Frank”),¹ more than four years ago. Since that time, those most affected by the financial crisis have made substantial strides to rebuild and move on (though, to be sure, for those most severely affected, progress has often been painfully slow). Of course, a substantial subset of those emerging from the crisis—namely, those comprising that vaguely defined group known as “Wall Street”—have also had to face adjusting to the new regulatory world that Dodd–Frank created. Still, commentary and debates about the new regulation and its proper focus and tools have largely faded, as firms have accepted and settled into their new obligations.

1. Dodd–Frank Wall Street Reform and Consumer Protection (Dodd–Frank) Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, 15 U.S.C.).

Or so it might seem. Despite the apparent return to calm and the emergence of other events to draw our attention—new securities statutes such as the Jumpstart Our Business Startups (“JOBS”) Act² and controversial Supreme Court decisions, such as those in the *McCutcheon*³ and *Hobby Lobby*⁴ cases—much remains unsettled and problematic regarding one of the most critical components of Dodd–Frank. That component is Title VII of the statute, which sets forth a comprehensive and entirely new regulatory regime governing swaps.

“Swaps” are a type of derivative financial instrument, meaning that their value is derived from the value (including the expected future value) of some other financial instrument.⁵ They are just one of several types of instruments falling within the derivative category. Others are options and warrants, the value of which is derived from the value of particular securities, and futures contracts, whose values are derived from the value of particular commodities or securities.⁶ Swaps, moreover, are a derivative of the “over-the-counter,” or “OTC,” variety, meaning that, at least traditionally, parties enter into them privately, outside of any formal exchange mechanism.

Swaps were the anointed culprits behind much of the financial crisis’s worst assaults on asset values. Recall AIG’s near-bankruptcy, the product of the firm’s extensive transactions in a certain type of swap—namely, “credit default” swaps.⁷ AIG, moreover, was not alone. Many financial institutions served as willing counterparties for credit default swaps at the time, given the robust demand for them—but then defaulted on them (or risked defaulting on them) as the housing bubble burst, thereby feeding the systemic contagion that produced the crisis. Still, the rationale for financial and commercial firms’ extensive swap participation was clear: They sought to hedge risks, such as the risk of default on mortgage-related or other liabilities,⁸ and viewed using swaps as a cost-effective way to do that.⁹ Swap transactions, after all, were not regulated.¹⁰ In 1999 Congress effectively forbade both the Securities and

2. Jumpstart Our Business Startups (JOBS) Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified as amended in scattered sections of 15 U.S.C.).

3. *McCutcheon v. Fed. Election Comm’n*, 134 S. Ct. 1434 (2014).

4. *Burwell v. Hobby Lobby Stores, Inc.*, 134 S. Ct. 2751 (2014).

5. See *infra* note 36 and accompanying text (defining “derivative”).

6. See *infra* notes 33–42 and accompanying text (describing different types of derivatives).

7. See *infra* notes 78–91 and accompanying text (describing AIG’s activities in the swap markets).

8. See Kimberly D. Krawiec, *Derivatives, Corporate Hedging, and Shareholder Wealth: Modigliani–Miller Forty Years Later*, 1998 U. ILL. L. REV. 1039, 1040 (“Corporate America considers risk management vitally important and considers derivative financial products an indispensable tool for managing many types of financial risk regularly faced by today’s corporations.”).

9. See Complaint at 49, *Sec. Indus. & Fin. Mkts. Ass’n v. U.S. Commodity Futures Trading Comm’n*, No. 13-CV-1916 (D.D.C. Dec. 4, 2013) (noting that swaps have been a “cost-efficient[]” hedging tool).

10. See *infra* notes 126–31 and accompanying text (discussing swaps’ historically unregulated status).

Exchange Commission (“SEC”) and the federal agency regulating commodity futures, the Commodity Futures Trading Commission (“CFTC”), from taking any steps to change that circumstance.¹¹

This hands-off approach for swaps may have been, in part, a product of the fact that financial-related policymaking focused on transactions involving investing, particularly in securities, and not on those involving pretending. That is, securities transactions, which are governed by extensive federal regulation, fall under the rubric of “investing”—involving an investor’s deriving value from an asset actually purchased—whereas swap transactions may be more aptly characterized as exercises in “pretending.” Swaps involve pretending because, unlike securities-related transactions, a swap does not involve buying or selling anything—it is an agreement between private parties to speculate on the value of some “reference asset.” Importantly, the reference asset is wholly unrelated to the swap itself, a characteristic not typical of all derivatives.¹² Yet both parties pretend otherwise, agreeing that changes in the value of the reference asset will determine what sums the parties owe to one another under the swap.¹³

In stepped Dodd–Frank. Although not everyone embraced the particular approach to regulating swaps that Congress ultimately chose,¹⁴ swap regulation is arguably not among the statute’s most controversial changes.¹⁵ Dodd–Frank provides only part of the story of the new regulation, however, in that the statute sets forth only a broad vision of how regulation going forward will look. The other part of the story consists of the hundreds of rules that the relevant regulatory agencies created, or are in the process of creating, pursuant to their respective mandates under Dodd–Frank.¹⁶ Those rules refine, elaborate, and implement Congress’s regulatory objectives by specifying concrete requirements for the conduct of financial firms’ businesses.¹⁷

11. See *infra* notes 126–31 and accompanying text.

12. See *infra* notes 106–12 and accompanying text (comparing swaps to other types of derivatives).

13. See *infra* notes 106–12 and accompanying text.

14. See Hester Pierce, *Title VII: Derivatives*, in *DODD–FRANK: WHAT IT DOES AND WHY IT’S FLAWED* 77–88 (Hester Pierce & James Broughel eds., 2012), available at <http://mercatus.org/sites/default/files/publication/dodd-frank-FINAL.pdf> (arguing, on multiple grounds, that Title VII is problematic).

15. Dodd–Frank’s provisions prohibiting financial firms from engaging in certain investment-related activities (implemented through the CFTC’s “Volcker Rule”) and creating the Consumer Financial Protection Bureau seemed to attract more controversy, as compared with Title VII. See, e.g., *The Dodd–Frank Act: Too Big Not to Fail*, *ECONOMIST* (Feb. 18, 2012), <http://www.economist.com/node/21547784> (reporting various criticisms of the statute).

16. See *id.* (noting that Dodd–Frank contains approximately “400 rule-making requirements”).

17. See Frank A. Mayer, III & Ahmad M. Hajj, *Executive Order 13,563 and the United States Supreme Court’s Decision in Mayo: Impact on Current and Upcoming Dodd–Frank Rulemakings*, *BANKING & FIN. SERVICES POL’Y REP.*, June 2011, at 4 (observing that “various federal banking and securities agencies are releasing a significant amount of rules to implement and interpret [Dodd–Frank]”).

In the swaps context, the “relevant regulatory agencies” are the CFTC and the SEC, which Dodd–Frank tasked with fleshing out the particulars of the new regulation of swaps.¹⁸ The CFTC—which has regulatory responsibility for all but a small percentage of swaps and therefore is the primary swap regulator—began its rulemaking process shortly after Dodd–Frank’s enactment, and that process remains underway, although it is in its final stages.¹⁹ As a result, only recently did swap users and their advisors (among others) apprehend that, taken together, the CFTC’s “swap rules” are wrongheaded—a conclusion produced by the CFTC’s predicating the rules on the accurate, but irrelevant, notion of swaps as instruments that necessitate pretending.

To be sure, the swap rules’ regulatory basis is not express; rather, it is evident in the rules’ formulation. And, to be sure, pretending—unregulated pretending, at least—is problematic. Swaps’ basis in pretending means, for example, that those who seek and provide credit protection through credit default swaps largely have no connection to the “things” to which the swaps refer.²⁰ Consider the contrast: Because those who invest in securities actually buy securities, and those who short securities actually borrow securities and return securities to the lender, there necessarily is a limit to the amount of investing that may be done at any given time. Pretense inflamed the financial crisis because it has no such limits—everyone can pretend and, beyond that, can pretend to own or have “exposure” to exactly the same debts, securities, or other instruments as everyone else.²¹ Moreover, there is the possibility of rampant pretenders—firms that have entered into countless swaps of the same type or having the same reference asset. In short, the possible scope of pretending in the credit default swap context multiplies the potential for systemic contagion, arguably without a corresponding benefit to the economy—or, indeed, to anything else.²²

18. See *infra* notes 141–56 and accompanying text (listing some of Title VII’s rulemaking mandates).

19. See *Dodd–Frank Final Rules, Final Guidance, Final Exemptive Orders, and Other Final Actions*, U.S. COMMODITY FUTURES TRADING COMMISSION, <http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankFinalRules/index.htm> (last visited Mar. 18, 2015) (noting that the agency “began issuing proposed rules” under Dodd–Frank in August 2010 and remains “in the process of implementing [Dodd–Frank]” as of the publishing of this Article).

20. See *infra* Part II.B (describing financial firms’ use of swaps in the financial-crisis era).

21. See *infra* notes 113–16 and accompanying text (discussing the limitless nature of swaps); 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 195 (2011) [hereinafter INQUIRY REPORT], available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> (observing that, in the financial crisis era, firms often entered into credit default swaps not to insure assets they actually owned but, rather, to make “side bets on the risks undertaken by others”).

22. See *infra* notes 73–93 and accompanying text (discussing swaps’ contributions to the financial crisis).

Nonetheless, pretending is not an appropriate basis of regulation. This Article critically evaluates the swap rules to identify the regulatory vision that they reflect. Through focusing on two important sets of rules—those defining who is a “swap dealer” required to be regulated as such and those prescribing Title VII’s extraterritorial application—it shows how the swap rules are predicated on a notion of swaps as instruments based on pretending.²³ It argues that this (unacknowledged) foundation of the CFTC’s rulemaking is inappropriate²⁴ because the mode of regulation it produces imposes excessive regulatory costs on those seeking efficient means to hedge their everyday business risks—namely, commercial “end users,” the swap-market equivalents of securities market investors.

This Article’s project additionally involves highlighting a critical characteristic of pretending, namely, that it is fundamentally bilateral: Both parties to a swap pretend.²⁵ Thus, many of the swap rules, especially the more troublesome ones, apply to both parties, if not in express terms then almost certainly in effect, and do not aim to diminish information or power imbalances in the parties’ relationship. In other words, the rules apply both to financial market professionals who transact in swaps as a business and to end users themselves.²⁶ An equivalent approach in the securities context would be for the SEC to apply its rules both to investors (those deemed to need the protection of regulation) and to issuers and securities market intermediaries (those against whom investors need protection).

Certainly, when the financial instrument to be regulated involves (bilateral) pretending, rather than (unilateral) investing, there may be some logic behind founding policymaking on that fact. That is, if there is no “issuer,” as there is in the securities context, then, consistent with Congress’s pre-Dodd–Frank approach, perhaps there is no reason to regulate the instrument at all. Or, conversely, if there is no issuer, then, consistent with the CFTC’s current approach, perhaps there is no reason *not* to apply regulation to both the financial market professional and the end user. There is no need to pursue that question further, however, because the key to understanding the CFTC’s approach is the apparent circumstance that the agency does not regard a swap as involving *no* issuer. Rather, it deems a swap to involve *two* issuers²⁷—a conception that readily produces the conclusion that it is as necessary to regulate the market professional as it is to regulate the end user.

23. See *infra* Part III.

24. See *infra* Part IV.A.

25. See *infra* notes 259–60 and accompanying text (discussing the bilateral nature of swaps).

26. See *infra* notes 195–99 & 262–63 and accompanying text (arguing that the swap rules inappropriately apply to end users).

27. 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. 30,596, 30,607 (proposed May 23, 2012) (to be codified at 17 C.F.R. pt. 240) [hereinafter

The problem with this framework, which the CFTC seems to ignore, is that end users cannot be considered issuers to the same extent as swap dealers. Furthermore, it is apparent from Dodd–Frank’s text that Congress perceived that the burden of regulation should fall on swap dealers²⁸—the AIGs of the swap markets—presumably since their activities (and not those of end users aiming to hedge commercial risk) were primarily responsible for the systemic weaknesses that swaps created six years ago.²⁹ The problem is more than academic, moreover. Among other things, by adopting too broad a definition of “swap dealer,” thereby subjecting end users to regulation that is equal in many respects to the regulation to which swap dealers are subject, and by further elevating pretending as a regulatory foundation in its “cross-border” rules, the CFTC may have led firms that might turn to swaps as an efficient hedging tool to rely on other (possibly less cost-effective) instruments for that function.³⁰ In short, the CFTC’s over-extension of regulation’s boundaries arguably contradicts Congress’s determination that swaps serve a worthy purpose in the financial markets and the goal that such a determination implies: creating and protecting a market that is stable (from a systemic risk standpoint), in which productive and value-enhancing swap transactions may occur.

Of course, all of this leads to the question: what is a better basis for regulation? The short answer is *speculation*. As noted above, the swap rules reflect that swaps involve pretending, which places them in contrast to other types of regulated financial instruments—particularly securities—which involve investing. However, focusing on that distinction, if only implicitly, for the purposes of swap regulation is misguided because of its assumption that securities regulation is likewise based on it. It is not. At the heart of securities regulation is the blunt circumstance that securities transactions are predicated on speculation: investors’ placing assets in a security because they

Swap Dealer Release] (“Each counterparty to a swap in essence is the ‘issuer’ of that instrument.”).

28. This is evident from the fact that a significant portion of the text of Title VII pertains or applies to swap dealers, whereas those who simply use swaps are only sporadically mentioned. *See, e.g.*, Dodd–Frank Act, Pub. L. No. 111-203, §§ 721-754, 124 Stat. 1376, 1658-754 (2010) (setting forth the regulation of swap markets other than security-based swap markets).

29. *See infra* notes 73-93 and accompanying text (describing AIG’s and other financial institutions’ roles in the financial crisis).

30. Although there is not yet sufficient data on this point to draw conclusions, both legislators and industry groups have speculated that the swap rules could reduce end users’ participation in the swap markets. *See* Complaint, *supra* note 9, ¶ 93 (opining that the CFTC’s cross-border rules “will create a preference for other products, such as futures”); *cf.* Letter from Spencer Bachus, Ranking Member, U.S. House Comm. on Fin. Servs., & Frank Lucas, Ranking Member, U.S. House Comm. on Agric., to The Honorable Timothy Geithner, Sec’y, U.S. Dep’t of Treasury, et al. (Dec. 16, 2010) [hereinafter Bachus Letter], *available at* <http://www.sec.gov/comments/s7-39-10/s73910-5.pdf> (contending that “[c]asting an overly-broad net in defining [swap dealer] could force some smaller participants to leave the marketplace”).

expect its value to increase or decrease, as the case may be.³¹ That activity, taken to an extreme in any particular dimension (such as the amount purchased, the type of security, or the frequency of transactions), creates risks for market participants, market integrity, and systemic stability. This logic informed Congress's approach to swap regulation in Dodd–Frank.³² It should also have informed the CFTC's formulation of the swap rules—but, unfortunately, it did not.

Part II lays the foundation for this Article's arguments, describing what swaps are and their purpose, the ways in which they contributed to the onset and severity of the financial crisis, the challenges that formulating swap regulation presents, and Dodd–Frank's general approach to swap regulation. With that background in place, Part III examines two sets of swap rules both to demonstrate how the rules reflect a conception of swaps as based on pretense and to highlight the problems that that circumstance spawns. Among the most formidable difficulties is that the costs of the swap rules may exceed their benefits, creating the conditions for inefficient swap markets and hindering the achievement of regulatory objectives. Part IV turns to the conclusions that we might draw from the particular brand of swap regulation that the CFTC has pursued. It argues that the rules reflect the bilateral regulatory approach that is entailed by the notion of swaps as pretense-based instruments and describes a better mode of regulation—one that looks to the securities regulatory model instead of eschewing it as inapposite. Specifically, much as securities regulation is founded on the problems associated with the speculation inherent in securities investing, so too must swap regulation be centered on the speculation required of swap participants. The Article concludes by suggesting that a reorientation of swap regulation is not only desirable, but also feasible.

II. THE DERIVATIVES KNOWN AS SWAPS

Derivatives come in many shapes and forms. The label encompasses options and warrants, instruments that are typically tied to securities.³³ A call option on a security, for example, entitles the holder to purchase a specified amount of the security at a specified price and within a particular period of time, while a put option entitles the holder to sell the security, subject to similar parameters.³⁴ Commodity futures contracts are also derivatives—

31. See *infra* notes 285–92 and accompanying text (discussing the role of speculation in the securities markets).

32. See *infra* Part II.D (summarizing Dodd–Frank's swap regulation).

33. See *6 Types of Equity Derivatives and Their Advantages*, INVESTORGUIDE.COM (Jan. 25, 2013), <http://www.investorguide.com/article/11842/6-types-of-equity-derivatives-and-their-advantages-igu> (“There are several different types of equity derivative[s]; including options, warrants, futures, forwards, convertible bonds, and swaps.”).

34. See *Call Option*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/calloption.asp> (last visited Mar. 18, 2015) (defining “call option” as “[a]n agreement that gives an investor the

traded on formal exchanges—obligating one party to the contract to purchase a specific amount of a commodity from the other party at a specific date.³⁵ In each case, the value of the instrument is determined based on—that is, derived from—the value of the underlying security or commodity.³⁶ Whereas options and warrants are subject to the same regulation as securities under the securities laws,³⁷ commodity futures contracts are regulated under the Commodity Exchange Act of 1936 (“CEA”) and the associated CFTC rules.³⁸

And then there are swaps. Swaps are essentially contracts that require each party to provide payments to the other upon the occurrence of events specified in the contracts.³⁹ Swaps have been called OTC derivatives, a label signifying that they do not involve formal exchanges but, rather, are agreements negotiated between private, sophisticated parties.⁴⁰ Moreover, swaps come in many forms—there are total return swaps, foreign exchange swaps, interest rate swaps, and asset swaps—and serve varied purposes.⁴¹ Also within the “swap” category are credit default swaps, which achieved notoriety

right (but not the obligation) to buy a stock, bond, commodity, or other instrument at a specified price within a specific time period”); *Put Option*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/putoption.asp> (last visited Mar. 18, 2015) (defining “put option” as “[a]n option contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time”).

35. See *Commodity Futures Contract*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/commodityfuturescontract.asp> (last visited Mar. 18, 2015) (defining “commodity futures contract” as “[a]n agreement to buy or sell a set amount of a commodity at a predetermined price and date” and noting that “[b]uyers use these to avoid the risks associated with the price fluctuations of the product or raw material, while sellers try to lock in a price for their products”).

36. See *Derivative*, FREE DICTIONARY, <http://financial-dictionary.thefreedictionary.com/Derivative> (last visited Mar. 18, 2015) (defining “[d]erivative” as “[a] financial contract whose value is based on, or ‘derived’ from, a traditional security (such as a stock or bond), an asset (such as a commodity), or a market index”).

37. This is evident from, among other things, the fact that the Securities Act includes options and warrants in the definition of “security.” 15 U.S.C. § 77b(a)(1) (2013) (“The term ‘security’ means any . . . put, call, straddle, option, or privilege on any security, . . . or any . . . warrant or right to subscribe to or purchase, any of the foregoing.”).

38. Commodity Exchange Act (CEA), 7 U.S.C. § 1 (2012); see Jerry W. Markham, *Prohibited Floor Trading Activities Under the Commodity Exchange Act*, 58 FORDHAM L. REV. 1, 4 (1989).

39. See *Definition of Swap*, FIN. TIMES, <http://lexicon.ft.com/Term?term=swap> (last visited Mar. 18, 2015) (defining “swap” as “[a]n exchange of streams of payments between two parties”).

40. See Michael McCaffrey, *An Introduction to Swaps*, INVESTOPEDIA, <http://www.investopedia.com/articles/optioninvestor/07/swaps.asp> (last visited Mar. 18, 2015) (noting that “[u]nlike most standardized options and futures contracts, swaps are not exchange-traded instruments” and that “[i]nstead, swaps are customized contracts that are traded in the over-the-counter (OTC) market between private parties”).

41. See *An In-Depth Look at the Swap Market*, INVESTOPEDIA, <http://www.investopedia.com/articles/trading/11/introduction-swap-market.asp> (last visited Mar. 18, 2015) (describing different types of swaps).

during and after the financial crisis for having been a primary cause of it.⁴² This Part sets forth the background necessary for Part III's discussion of the CFTC's swap rules. Subpart A explains how swaps work, while Subpart B summarizes their role in the financial crisis. Subpart C describes how the nature of swaps creates regulatory challenges, and Subpart D outlines Dodd-Frank's approach to swap regulation.

A. SWAPS

"Swaps" are agreements to exchange (to "swap") money. For any given swap, how much money will be exchanged and at what times depends on the reference asset. For example, a typical total return swap has as its reference asset a particular amount of a particular security—100 shares of Google, for example. One party to the swap holds the "long" side of the swap, effectively betting that the reference asset will increase in value or is otherwise a sound asset, while the other party holds the "short" side, effectively betting that the reference asset will decline in value or that there will be a default as to it. Every swap, then, comprises a long leg and a short leg—its yin and yang, two sides of a single coin. This section describes how swaps work and the role they play in the financial markets.

1. Their Nature

Swaps allow parties to speculate on the value of some reference asset. For illustration purposes, let us assume that Party A and Party B enter into a swap that has as its reference asset the 100 shares of Google noted above. Party A has the long leg, and Party B has the short leg. If, over the term of the swap, Google stock increases in value, Party B will be obligated to pay the amount of that increase per share (times 100) to Party A. And if Google declares and pays any dividends to its shareholders, Party B will be obligated to pay the amount of each dividend per share (times 100) to Party A. As a result of those payments, over the term of the swap Party A will have the experience of owning 100 Google shares without actually owning them. The benefit to Party A should be evident: If the market price of Google stock were, say, \$50 per share at the time the parties execute the swap, then, by using the swap to gain exposure to Google, Party A is able to retain in its bank account—or deploy for other purposes—the \$5000 that it would otherwise have used to buy those 100 shares. Because of the swap, it is as though Party A borrowed \$5000, rather than use its own funds, for the purpose of investing in Google.

Of course, Party A did not actually borrow anything to achieve the effect of owning—that is, having a long position in—Google stock. But the fact that the swap creates that effect is incorporated into the swap's terms. Just as Party

42. See René M. Stulz, *Credit Default Swaps and the Credit Crisis* 3–4 (Nat'l Bureau of Econ. Research, Working Paper No. 15384, 2009), available at <http://www.nber.org/papers/w15384.pdf> (describing the ways in which credit-default swaps exacerbated the financial crisis).

B is responsible for paying to Party A amounts that Party A would receive if it actually owned 100 shares of Google, Party A must pay to Party B amounts equal to the interest that Party A would pay if it had actually borrowed \$5,000, based on an agreed-upon interest rate.

Moreover, recall that Party B holds the short leg of the swap and is the side wagering, in our example, that Google's prospects are dismal. As a result, Party A is also obligated to pay to Party B any amounts by which a share of Google declines in value over the swap's term (times 100). Accordingly, just as the swap gives Party A the experience of buying and holding Google stock, it creates for Party B the experience of having sold 100 shares of Google short.⁴³

As its name implies, then, a total return swap gives Party A the total "upside" to owning the reference securities, while it gives Party B the total downside to owning those securities, as well as the amounts a lender would earn as interest if it had loaned to Party A the amount necessary to actually buy the securities.⁴⁴ That amount is the "notional" amount—the label attached to the value of the reference asset.⁴⁵ But again, in entering into a swap, neither Party A nor Party B buys, sells, or borrows anything from anyone.⁴⁶ The parties merely enter into an agreement to give each other the experience of having borrowed funds and purchased securities, on the one hand, and having loaned funds and "shorted" securities, on the other.⁴⁷ In

43. In a short sale, a trader borrows stock from a broker or other securities lender and sells it in the open market, with the hopes that the market price for the stock will thereafter decrease. See Matthew Lewis, *A Transatlantic Dilemma: A Comparative Review of American and British Hedge Fund Regulation*, 22 EMORY INT'L L. REV. 347, 358 (2008) (describing the process of selling securities short). Later on, the trader will purchase in the open market the same amount of the same security that she borrowed and will return those shares to the broker, in satisfaction of her debt. See *id.* If all went well and the expected depreciation occurred, the trader will have earned as a profit the drop in price—the difference per share between the price at which she sold the shares that she borrowed and the price at which she later purchased replacement shares. See *id.*

44. See, e.g., *CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP*, 654 F.3d 276, 279 (2011) (explaining that "[t]otal-return swaps are contracts in which parties agree to exchange sums equivalent to the income streams produced by specified assets" and that they "involve an exchange of the income stream from: (1) a specified number of shares in a designated company's stock, and (2) a specified interest rate on a specified principal amount"); Janet Tavakoli, *Introduction to Total Return Swaps*, TAVAKOLI STRUCTURED FIN., INC., <http://www.tavakolistructuredfinance.com/trs/> (last visited Mar. 18, 2015) (generally describing the payment arrangements associated with total return swaps).

45. See Mark A. Guinn & William L. Harvey, *Taking OTC Derivative Contracts as Collateral*, 57 BUS. LAW. 1127, 1130 n.11 (2002) ("The notional amount of a derivative transaction is a theoretical amount that is used to calculate the payment or delivery obligations under the transaction.")

46. See *CSX Corp.*, 654 F.3d at 279 (noting that total return swaps "do not transfer title to the underlying assets or require that either party actually own them"); Michael J. de la Merced, *A Legal Solution*, N.Y. TIMES (Sept. 12, 2008), <http://query.nytimes.com/gst/fullpage.html?res=9F06E5D9103CF931A2575ACoA96E9C8B63> (observing that total return swaps merely "give investors what they call 'economic exposure' to . . . companies").

47. As the CSX court observed,

short, the parties to a swap effectively agree to pretend that they have done those things.

Of course, there are many types of swaps, referencing different assets and requiring different types of payment streams based on those assets.⁴⁸ Interest rate swaps, for example, obligate each party to pay the other party “interest” on a designated principal amount over the term of the swap, with one party’s payments typically based on a fixed rate of interest and the other’s based on a floating rate.⁴⁹ A party might take the long leg of the floating rate (and, therefore, the short leg of the fixed rate)—receiving the floating-rate payments and paying the fixed-rate amounts—if she believes that the floating rate may increase over the term of the swap.⁵⁰ The other party will necessarily have the opposite legs for each rate, profiting if the fixed rate is higher than the floating rate. Regardless of the specific terms, however, the swap provides the interest-related effect, for each party, of having both loaned and borrowed the principal amount. Yet neither party borrowed or loaned anything; they merely are pretending to have done so.

Credit default swaps differ substantially from the model of swap in which each party makes occasional payments to the other, such as payments representing interest on a hypothetical notional amount or the change in value of a security or other asset. Like other types of swaps, however, credit default swaps involve pretending. With a credit default swap, one of the parties—the short party—pretends that it has exposure to a debt or other liability.⁵¹ Under the swap, the short party must make periodic payments to the long party, and, if there is a default as to the reference asset—the liability—the long party must make a payout to the short party to cover the

[T]he long party periodically pays the short party a sum calculated by applying an agreed-upon interest rate to an agreed-upon notional amount of principal, as if the long party had borrowed that amount of money from the short party. Meanwhile, the short party periodically pays the long party a sum equivalent to the return to a shareholder in a specified company—the increased value of the shares, if any, plus income from the shares—as if the long party owned actual shares in that company.

CSX Corp., 654 F.3d at 279.

48. See *supra* notes 41–42 and accompanying text (listing types of swaps).

49. See *Definition of Interest Rate Swap*, FIN. TIMES, <http://lexicon.ft.com/Term?term=interest-rate-swap> (last visited Mar. 18, 2015) (“An interest rate swap is a contract to exchange fixed payments for floating payments linked to an interest rate, and is generally used to manage exposure to fluctuations in interest rates.”); *Interest Rate Swap*, INVESTOPEDIA, <http://www.investopedia.com/terms/i/interestrateswap.asp> (last visited Mar. 18, 2015) (defining “interest rate swap” as “[a]n agreement between two parties . . . where one stream of future interest payments is exchanged for another based on a specified principal amount,” which typically provides for the “exchange [of] a fixed payment for a floating payment that is linked to an interest rate”).

50. See *Definition of Interest Rate Swap*, *supra* note 49 (describing uses for interest rate swaps).

51. See *Credit Default Swap—CDS*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/creditdefaultswap.asp> (last visited Mar. 18, 2015) (defining “credit default swap” as “[a] swap designed to transfer the credit exposure of fixed income products between parties”).

imaginary loss associated with the default on the liability.⁵² Accordingly, we might say that the long party pretends that it is an insurer, willing to assume the risk of a possible default based on an optimistic view of the repayment prospects as to the reference liability.⁵³ Similarly, the short party pretends that it is an insured, hoping for a compensatory payout based on a pessimistic view regarding those same prospects.

The swaps in the examples above involve the pretense associated with any swap, regardless of whether the parties use them for hedging purposes or otherwise. The pretense is that, within the four corners of the swap contract, each of the parties borrowed a certain amount of funds from the other, bought a certain amount of stock, or sold a certain amount of stock short. To be sure, it is important not to overstate the point. Swaps are only one of many financial market transactions that allow participants to gain exposure to profit- (or loss-) producing assets. Even so, pretending is unique to swaps.

2. Their Purpose

Swap participants commonly enter into swaps because the participants actually have exposure to the reference asset (apart from the “synthetic” exposure created by the swap itself).⁵⁴ Thus, a swap may provide a means of hedging that exposure—that is, of *transferring* to another party the risk associated with it.⁵⁵ For example, if Party B in the example of the total return swap above actually owns 100 shares of Google, then taking the short leg of a total return swap that has the same amount and number of Google shares as its reference asset permits Party B to reduce the risk arising from owning Google stock. That is, if Google stock appreciates, then Party B benefits through its actual stock holdings; if Google stock depreciates, then Party B benefits through its swap because, now, Party A bears the risk of that depreciation.

Similarly, using an interest rate swap as an example, if a firm has borrowed \$100,000 from a bank at a fixed rate of interest, the firm might wish to reduce or eliminate the risk that a floating rate will become more favorable (that is, lower) over the term of the loan by entering into a swap with the same

52. See *Credit Default Swap Definition*, THESTREET, <http://www.thestreet.com/topic/47402/credit-default-swap.html> (last visited Mar. 18, 2015) (noting that “the seller of the [credit default] swap will pay the buyer in the case of a credit event (default) by a third-party” and that “[i]f no default occurs, the seller of the swap will have collected a premium from the buyer”).

53. Cf. *Credit Default Swap—CDS*, *supra* note 51 (“The buyer of a credit default swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the debt security.”).

54. See, e.g., Janis Sarra, *Equity Derivatives and the Challenge for Berle’s Conception of Corporate Accountability*, 36 SEATTLE U. L. REV. 1117, 1128 (2013) (observing that parent companies use swaps “to hedge risks associated with . . . companies in which they are directly invested”).

55. See Bruce S. Darringer, *Swaps, Banks, and Capital: An Analysis of Swap Risks and a Critical Assessment of the Basle Accord’s Treatment of Swaps*, 16 U. PA. J. INT’L BUS. L. 259, 295 (1995) (“[S]waps . . . are often used to hedge risks of other assets on the balance sheet.”).

term that refers to a notional amount of \$100,000. The firm would take the long side of the fixed-rate payments and the short side of the floating-rate payments—meaning that it would receive the former (equal to the interest payments it must make on its actual loan) from the other party and pay the latter to that other party. The swap would constitute protection against falling floating rates because it would effectively transform, from fixed to floating, the rate applicable to the net interest payments the firm must make, considering both the loan and the swap. And the firm would have transferred to the other party the risk that floating rates will be lower than fixed rates.

Credit default swaps may also be used as hedging tools. For example, if a bank has loaned \$10 million to the local widget factory, it may enter into a credit default swap with another party to eliminate the default risk associated with the loan. The swap would refer to a notional amount of \$10 million and specify that the bank will make periodic payments—equivalent to premiums in the insurance context—to the other party over the term of the swap. The other party, who now bears the default risk, would be obligated to make a one-time payment to the bank if one of any number of specified “default events” occurs. Those triggering events could be, for example, the downgrading of the factory’s credit rating, its bankruptcy, or, of course, its actual default on the loan.⁵⁶

The usefulness of swaps is not limited to transferring risk. Parties may also use swaps for purposes of pure profit generation.⁵⁷ For example, if a hedge fund believes that Twitter stock will appreciate in value but does not want to deploy the capital to buy Twitter stock, the fund could enter into a total return swap, taking the long leg. If the fund has not taken a short position vis-à-vis Twitter in another transaction, then its swap does not serve a risk-mitigation function. Similarly, if the fund believes that General Motors (“GM”) will default on the bonds it recently issued to the public, then it can enter into a credit default swap that uses GM bonds as the reference liability, taking the short leg—even if it has no long exposure to GM bonds elsewhere. If the fund is correct in its assessments of the profitability of such a transaction, the resulting profits are indeed pure profit because they are not offset by losses from another transaction in which the fund assumed the opposite stance. But it works both ways. If the fund is incorrect and has no offsetting position, it will sustain pure losses.

56. Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 52 (2011) (“Credit events triggering payment on CDSs typically include default and bankruptcy by the reference entity, but CDSs may also protect against debt restructuring or credit rating downgrade.”).

57. See, e.g., Alexandros Seretakis, *Hedge Fund Activism Coming to Europe: Lessons from the American Experience*, 8 BROOK. J. CORP., FIN. & COM. L. 438, 464 n.163 (2014) (“Equity derivatives such as total return swaps allow an activist [investor] to increase its economic exposure to the target [company] and gain additional profits from a share price appreciation without increasing its voting rights.”).

B. SWAPS AND THE FINANCIAL CRISIS

The ways in which swaps—credit default swaps, in particular—fueled the financial crisis have been amply chronicled elsewhere.⁵⁸ Painted with broad brush strokes, the picture begins with an asset price bubble in the national housing market.⁵⁹ The bubble was, in part, a product of the ways in which institutions involved in mortgage lending, either as originators or purchasers of mortgages, transferred the default risk associated with the mortgages.⁶⁰ Since the early 1970s, loan originators had been able to shed themselves of mortgage-default risk by selling the loans to third parties—primarily the government agencies Fannie Mae and Freddie Mac,⁶¹ but also, in the years leading up to the crisis, myriad other financial institutions.⁶² At one point or another in those years, those other financial institutions joined Fannie Mae and Freddie Mac in employing a financial tool designed to further spread and defuse default risk: securitization.⁶³

In the securitization process, financial institutions bundled together many mortgages and contributed them to investment entities (funds) in which investors purchased ownership interests. These ownership interests, by another name, were mortgage-backed securities (“MBS”)—debt securities backed by mortgages.⁶⁴ To address the concern that few investors wished to buy interests in the lower-rated “tranches” of mortgage bundles held by any particular fund, the sponsoring institutions pooled the lower-rated tranches of many such funds.⁶⁵ Because the pool of low-rated tranches, by definition, had greater diversification than the group of lower-rated tranches within any particular fund, the securities they issued—known as “collateralized debt obligations” (“CDOs”)—were, remarkably, usually rated triple-A.⁶⁶

58. See, e.g., INQUIRY REPORT, *supra* note 21, at 233–379 (detailing the role of credit default swaps in the financial crisis); ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES 159–60, 397–98 (2009) (describing the consequences of AIG’s extensive participation in credit default swaps).

59. See INQUIRY REPORT, *supra* note 21, at 157–59 (describing the emergence and growth of the housing bubble).

60. See *id.* at 125 (describing the “pipeline through which risky mortgages were conveyed and sold throughout the financial system”).

61. See *id.* at 38–42 (describing the functions of the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”).

62. See *id.* at 102 (“In 2004, commercial banks, thrifts, and investment banks caught up with Fannie Mae and Freddie Mac in securitizing home loans.”).

63. See *id.*

64. See *id.* at 42–45 (describing the pre-financial crisis growth of residential-mortgage securitization and the risk-transfer effects of securitization).

65. See *id.* at 127 (describing the process of repackaging the lower-rated tranches of many mortgage-backed funds into CDOs).

66. See *id.* (observing that CDOs were “mostly rated triple-A,” even though the reason for that rating “was not obvious”).

A mortgage pool's investors, then, ultimately bore the risk that the loans comprising the pool's portfolio would default—a risk that the investors were willing to bear in return for sharing in the interest payments that borrowers would pay on the mortgages.⁶⁷ After all, since the pools now owned the mortgages, the pools were entitled to receive borrowers' principal and interest payments on them.⁶⁸ In effect, securitizing mortgages not only transferred the default risk associated with them but also scattered it among many "lenders" (the pools' investors). Once neither mortgage originators nor mortgage purchasers had to bear any default risk, mortgage lending standards became increasingly lax and mortgages flowed freely.⁶⁹ Because almost anyone could obtain a mortgage—regardless of their personal assets or credit history and, in many cases, without making a down payment—housing demand grew.⁷⁰ Predictably, so did housing prices.⁷¹ Thus emerged the housing price bubble—and, as increasing numbers of homebuyers defaulted as interest rates on adjustable-rate mortgages ratcheted up, thus burst the bubble.⁷² And the financial crisis was underway.

The very existence of the housing price bubble meant that there had been substantial leverage—debt—in the economy.⁷³ Where there is debt, of course, there are lenders—those who bear the risk of default, whether they originated the particular loans at issue, bought them from someone else, or invested in a mortgage pool. And where there are lenders, there is risk—and attempts to mitigate it. Credit default swaps provide one way to do that.⁷⁴ By entering into a swap contract, a lender or pool investor can tailor protection to cover the risk of default on a particular debt, at the cost of a periodic payment tantamount to a premium.⁷⁵

67. See Andrey D. Pavlov & Susan M. Wachter, Essay, *Systemic Risk and Market Institutions*, 26 YALE J. ON REG. 445, 445 (2009) ("With private-label MBS, [as opposed to those sponsored by Fannie Mae, Freddie Mac, or other government-sponsored entities,] investors bore default risk.").

68. See Robert G. Gucwa, *The 2007 Collapse in Securitization: A Case for Regulatory Reform*, 14 N.Y.U. J. LEGIS. & PUB. POLY 245, 249 (2011) (observing that, in transactions in asset-backed securities, the investors "receive[] the right to all future principal and interest payments on those loans").

69. See INQUIRY REPORT, *supra* note 21, at 109–11 (chronicling the collapse in mortgage-lending standards).

70. See Winston Sale, *Effect of the Conservatorship of Fannie Mae and Freddie Mac on Affordable Housing*, 18 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 287, 295 (2009) ("Low interest rates and relaxed mortgage lending standards made homeownership possible for populations previously unable to qualify for mortgages, further increasing the demand for housing.").

71. See INQUIRY REPORT, *supra* note 21, at 156 ("Nationally, housing prices jumped 152% between 1997 and their peak in 2006, more than in any decade since at least 1920." (footnote omitted)).

72. See *id.* at 213–30 (detailing the bursting of the housing bubble).

73. See *id.* at 134 ("The mortgage pipeline . . . introduced leverage at every step.").

74. See *id.* at xxiv ("[Credit default swaps] were sold to investors to protect against the default or decline in value of mortgage-related securities backed by risky loans.").

75. See *supra* notes 51–53 and accompanying text (describing the structure of credit default swaps).

Yet, in the months leading to the financial crisis, lenders seeking to hedge their exposure to mortgage-related and other liabilities were only one set of participants in the credit default swap market. The other group comprised those who may have had no exposure to a particular debt—that is, they were not the originators or purchasers of the debt—but who had a view as to the risk of default as to it. If, for example, a financial firm believed that certain MBS or CDOs were good credit risks, they could enter into credit default swaps (on the long side) that referenced those securities.⁷⁶ Or, if an investor's financial advisor held a similar belief, the investor could participate in so-called synthetic CDOs—complex instruments not involving tranches of mortgage-backed securities but involving, instead, credit default swaps referencing those securities.⁷⁷

When housing prices began to collapse in 2007, and debtors throughout the economy defaulted, there arose the prospect that it would soon be time for those on the long side of many credit default swaps to pay out.⁷⁸ They were unable to uphold their obligations, however. The insurer AIG provides the most sobering example on this point. That company had “insured,” through credit default swaps, debt—mostly CDOs—with an aggregate notional value of almost half a trillion dollars.⁷⁹ It is not difficult to imagine that a payout of that magnitude was not possible, particularly because AIG had not hedged its possible obligations under its credit default swaps, such as by entering into offsetting credit default swaps as to which it held the short side.⁸⁰ That circumstance naturally raised the question of why the firm had put itself in such a precarious position.⁸¹ One answer is that it believed that the heady days of the housing bubble would never end or, at least, would not end any time

76. The final report of the Financial Crisis Inquiry Commission describes this phenomenon: “The purchasers of credit default swaps . . . profited spectacularly from the housing crisis, [but] they never made a single subprime loan or bought an actual mortgage. In other words, they were not purchasing insurance against anything they owned. Instead, they merely made side bets on the risks undertaken by others.” See INQUIRY REPORT, *supra* note 21, at 195.

77. See *id.* at 142 (explaining synthetic CDOs).

78. See *id.* at 265–74 (discussing AIG’s increasingly dire circumstances in 2008 as a dominant long party for credit default swaps).

79. See Nathaniel G. Dutt, *Current United States Credit Default Swap Regulatory Initiatives: A New World Standard or Just a Ploy?*, 16 ILSA J. INT’L & COMP. L. 169, 183–84 (2009) (noting that AIG’s credit default swaps “opened AIG to billions of dollars of potential losses and payouts, upon a credit event occurrence”).

80. See INQUIRY REPORT, *supra* note 21, at 266 (explaining that AIG did not “hedge its exposure” on its credit default swaps, “in part because of the mistaken belief that” payments to counterparties would be necessary “only if holders of the super-senior tranches” of the reference assets (largely CDOs) suffered losses).

81. See Robert Lenzner, *Why Wasn’t AIG Hedged?*, FORBES (Sept. 28, 2008, 1:25 PM), http://www.forbes.com/2008/09/28/croesus-aig-credit-biz-cx_rl_0928croesus.html (describing circumstances that may have led AIG to take on the exposure that it did).

in the foreseeable future.⁸² Based on such a belief, AIG could assume that it would never be called upon to pay and that, instead, it would simply be on the receiving end, accepting payments from its counterparties.

AIG was not alone in having extensive long exposure through credit default swaps. It was in the company of Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley, as well as scores of hedge funds.⁸³ Although many of these institutions, unlike AIG, did attempt to hedge their exposure on either the long side or the short side by entering into offsetting swaps,⁸⁴ that effort was only marginally successful, as the insolvencies of Bear Stearns and Lehman Brothers exemplify.⁸⁵ Hedging was not an answer for obvious reasons—if AIG or another long-side party could not make good on its payment obligations under its swaps, that would impede their short-side counterparties' ability to make good on their own long-side obligations.⁸⁶ If Merrill Lynch, for example, had hedged its own long exposure primarily by taking the short side of AIG's long-side swaps, the prospect that Merrill Lynch would be able to satisfy its long-side obligations would have diminished.⁸⁷ This state of affairs was exacerbated by the fact that both the value of collateral that firms had posted with lenders and the reference assets for many of their derivative agreements were (increasingly worthless) housing-related assets, such as mortgage-backed securities.⁸⁸ That circumstance, in turn, was further exacerbated by the fact that the challenged firms' credit ratings were simultaneously sinking—a separate consequence of

82. See INQUIRY REPORT, *supra* note 21, at 26–67 (stating that the actuarial model on which AIG relied “had determined with 99.85% confidence that the owners of the super-senior tranches of the CDOs insured by AIG . . . would never suffer real economic losses”).

83. See Jeff Merkley & Carl Levin, *The Dodd–Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats*, 48 HARV. J. ON LEGIS. 515, 527–29 (2011) (describing various financial firms' difficulties in 2007–08 and the ensuing government bailout).

84. See INQUIRY REPORT, *supra* note 21, at 234 (observing that “[i]n late 2006 and early 2007, some banks moved to reduce their subprime exposures by . . . buying protection through credit default swaps”).

85. See Jonathan Macey et al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages*, 34 J. CORP. L. 789, 804 (2009) (“In 2008 Bear Stearns collapsed and was acquired by JPMorgan Chase . . . [and] Lehman Brothers filed for bankruptcy.”).

86. See INQUIRY REPORT, *supra* note 21, at 299–300 (“If a party is unable to make . . . payments [under its credit default swaps] when they become due, that failure may cause significant financial harm to its counterparty, which may have offsetting obligations to third parties and depend on prompt payment.”).

87. The prospect that the difficulties experienced by one derivatives dealer would infect the activities of others was likely, given the small, interconnected character of the world of derivatives dealing. See Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders, Berkshire Hathaway Inc. (Feb. 21, 2003), in BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 14 (2003) [hereinafter Buffett Letter], available at <http://www.berkshirehathaway.com/2002ar/2002ar.pdf> (“Large amounts of risk . . . have become concentrated in the hands of relatively few derivatives dealers, who in addition trade extensively with one another.”).

88. See INQUIRY REPORT, *supra* note 21, at 234 (describing how financial institutions “had been busy for nearly four years creating and selling subprime-backed [CDOs]”).

their exposure to housing-related assets.⁸⁹ The devastating result of these events was that counterparties and lenders demanded ever-greater amounts of collateral as protection against default risk,⁹⁰ further draining the troubled firms' already-limited liquid assets.⁹¹

That is the systemic contagion that the financial crisis wrought. At the same time that triggering events for swap payouts were pervasive, so were parties' failures to meet their payment obligations. Moreover, any potential rescuers, such as institutions that could lend additional capital to or purchase an equity stake in the struggling firms, understandably kept their distance. Indeed, lending activity virtually stopped altogether, in a mammoth retraction of the credit markets that affected all parts of the economy, whether on Wall Street or on Main Street.⁹² There was no telling, after all, the extent to which would-be borrowers held stakes in investments and other instruments—so-called “toxic” assets⁹³—that reflected a positive view of the housing market.

C. CHALLENGE TO REGULATION

In light of the risk-transferring role of credit default swaps, it is not surprising that these swaps are deemed to have been a primary contributor to the length and severity of the financial crisis. Also not surprisingly, what to “do” with credit default swaps, from a regulatory perspective, was at the forefront of policymakers' concerns following the crisis.⁹⁴ And, post-crisis, regulate policymakers did, as Subpart D details. Dodd–Frank required parties to buy and sell swaps using clearinghouses and mandated that those who deal

89. See *id.* at 273; *cf. id.* at 243 (noting the concern of AIG executives that AIG's credit default swaps required AIG to post collateral to its counterparties if either “the market value of the referenced securities decline[d] by a certain amount” or if “rating agencies downgrade AIG's long-term debt”).

90. See *id.* at 234 (observing that, over the course of 2007, “repo lenders became less and less willing to accept subprime and Alt-A mortgages or mortgage-backed securities as collateral”).

91. See *id.* at 293–96 (describing how lenders who provided funding to troubled financial institutions through repurchase agreements (repos) imposed ever greater “haircuts” on the value of the collateral they held); Buffett Letter, *supra* note 87, at 14 (observing how counterparties' demands for collateral worsen the problems of firms experiencing financial difficulties).

92. See Jeff Sommer, *Seeking Solace? You'll Find Little in the Bond Market*, N.Y. TIMES, (Nov. 22, 2008), <http://www.nytimes.com/2008/11/23/business/23safe.html> (“Much of the turmoil in the financial sector and the overall economy has emanated from the credit markets.”); Andrew Ross Sorkin et al., *As Credit Crisis Spiraled, Alarm Led to Action*, N.Y. TIMES (Oct. 1, 2008), <http://www.nytimes.com/2008/10/02/business/02crisis.html> (observing that, in September 2008, “the credit markets had almost completely frozen up,” and “[b]anks were refusing to lend to other banks”).

93. See Max Holmes, Op-Ed., *Good Bank, Bad Bank; Good Plan, Better Plan*, N.Y. TIMES, (Jan. 31, 2009), <http://www.nytimes.com/2009/02/01/opinion/01holmes.html> (explaining that assets are “toxic” to the extent they are “illiquid, volatile and at depressed prices”).

94. See Christian Johnson, *Regulatory Arbitrage, Extraterritorial Jurisdiction, and Dodd–Frank: The Implications of US Global OTC Derivative Regulation*, 14 NEV. L.J. 542, 555–59 (2014) (describing the post-financial crisis push to regulate swaps and other OTC derivatives).

in swaps be registered as such with either the SEC or the CFTC.⁹⁵ Before turning to that discussion, however, it is worth considering the challenges of regulating swaps—challenges that stem from the circumstance that perhaps no other financial instrument is, at once, both exceedingly appropriate and exceedingly inappropriate for regulation.

Of course, one might logically question how regulating swaps can be inappropriate, particularly considering the extensive and complete regulation of securities that has existed since the 1930s⁹⁶ and the similarly extensive regulation of commodity futures, which originated during the same era.⁹⁷ After all, both securities and commodity futures are, like swaps, financial instruments.⁹⁸ Although policymakers, commentators, and scholars regularly question the particular forms that securities regulation, for example, has assumed,⁹⁹ few question the need for it.

Swaps are different from securities, however, in that they are not investments. Investments are assets that investors buy based on the prospect that the assets will generate income or increase in value over time.¹⁰⁰ Accordingly, both equity securities and debt securities are investments. Of course, so is artwork and real estate. However, from a regulatory perspective, securities are special as among investments because they are intangible.¹⁰¹ They cannot be inspected, as a house can be; they cannot be weighed, as gold can be. Securities investors, therefore, have a particular need for truthful information about them and the entities that issue and sell them, and

95. See *infra* notes 135–55 and accompanying text (describing Dodd–Frank’s regulation of swaps and swap participants).

96. See Nicholas L. Georgakopoulos, *Financial Armageddon Routs Law Again*, 14 U.C. DAVIS BUS. L.J. 1, 4 (2013) (“The backbone of securities regulation was created in the 1930s as a reaction to the crash that led to the Great Depression.”).

97. See Jerry W. Markham, *The Commodity Exchange Monopoly—Reform Is Needed*, 48 WASH. & LEE L. REV. 977, 982 (1991) (observing that commodity futures regulation came about in 1936).

98. The breadth of the term “financial instrument” is evident from its definition. See, e.g., *Financial Instrument*, BUSINESSDICTIONARY.COM, <http://www.businessdictionary.com/definition/financial-instrument.html> (last visited Mar. 18, 2015) (defining “financial instrument” as “[a] document (such as a check, draft, bond, share, bill of exchange, futures or options contract) that has a monetary value or represents a legally enforceable (binding) agreement between two or more parties regarding a right to payment of money”).

99. See, e.g., Gretchen Morgenson, *Investing: Wall St. Reform Falls Short, Survey Says*, N.Y. TIMES (Aug. 31, 2003), <http://www.nytimes.com/2003/08/31/business/investing-wall-st-reform-falls-short-survey-says.html> (reporting that professional money managers were skeptical of Congress’s post-Enron changes to the securities laws).

100. See *Investment*, INVESTOPEDIA, <http://www.investopedia.com/terms/i/investment.asp> (last visited Mar. 18, 2015) (defining “investment” as “[a]n asset or item that is purchased with the hope that it will generate income or appreciate in the future”).

101. See Norman S. Poser, *When ADR Eclipses Litigation: The Brave New World of Securities Arbitration*, 59 BROOK. L. REV. 1095, 1096 (1993) (noting that “securities are intangible merchandise, the sale of which is peculiarly subject to abuse”).

ensuring the provision of that information is the securities laws' signal objective.¹⁰²

Strictly speaking, an investor's short positions—in which the investor borrows a security that it then sells, with the hopes that the security will decline in value—are not “investments” as to that investor.¹⁰³ However, every short sale necessarily involves a purchaser on the opposite side of the transaction.¹⁰⁴ Hence, short sales, like any sale of securities, fall within the ambit of securities regulation.¹⁰⁵ The same is true of options and warrants on securities.¹⁰⁶ To be sure, options and warrants are derivatives,¹⁰⁷ in the sense that the value and existence of an option or a warrant is derived from the security on which it is based.¹⁰⁸ Nonetheless, an investor's exercise of an option or warrant entails either an investment in the underlying security or disposing of such an investment.¹⁰⁹ Options and warrants, in other words, are unexercised rights to buy or sell securities—transactions that are the core subject matter of securities regulation.

Swaps, by contrast, involve neither purchasing an asset (or the right to purchase an asset) nor selling one. Rather, they are simply contracts between

102. See, e.g., Robert J. Rhee, *On Duopoly and Compensation Games in the Credit Rating Industry*, 108 NW. U. L. REV. 85, 103 n.108 (2014) (“It is axiomatic that the predominant regulatory philosophy in securities regulation is disclosure of information.”).

103. For a description of the process of selling a security short, see *supra* note 43 and accompanying text.

104. See *supra* note 43 and accompanying text.

105. For example, the SEC's Regulation SHO provides that, before accepting an order to effect a short sale, a broker-dealer must either have borrowed the security on behalf of the short seller or have reasonable grounds to believe that it can borrow the security. 17 C.F.R. § 242.203(b)(1) (2014). In addition, the SEC's Regulation M prohibits the purchase of securities in a secondary or follow-on offering if the purchaser has sold the stock short within a certain period prior to the time the offering price is set. See *id.* § 242.105(a).

106. See *supra* note 37 and accompanying text (noting that options and warrants are generally regulated under the securities laws).

107. See John W. Hill et al., *Increasing Complexity and Partisanship in Business Damages Expert Testimony: The Need for a Modified Trial Regime in Quantification of Damages*, 11 U. PA. J. BUS. L. 297, 349 (2009) (“Common equity can be of various classes and can have various forms of derivative securities attached, such as stock options and warrants.”).

108. Note, *Private Causes of Action for Option Investors Under SEC Rule 10b-5: A Policy, Doctrinal, and Economic Analysis*, 100 HARV. L. REV. 1959, 1977 (1987) (“[T]he values of option contracts are determined in large part by the price of the underlying security and its volatility.”); cf. Stéphane Rousseau, *The Future of Capital Formation for Small and Medium-Sized Enterprises: Rethinking Initial Public Offering Regulation After the Restructuring of Canadian Stock Exchanges*, 34 REVUE JURIDIQUE THÉMIS (n.s.) 661, 704 (2000) (Can.) (“If the securities are overpriced in the IPO, their price will go down after the offering and the warrants will become less valuable.”).

109. Cf. *Regulation D Offerings and Private Placements* (ALI-ABA Course of Study, Mar. 15–17, 2012), WL ST029 ALI-ABA 569 (discussing the position of the SEC's Division of Corporate Finance that, “upon a cashless exercise of options or warrants, the newly acquired underlying securities are deemed to have been acquired when the corresponding options or warrants were acquired”).

sophisticated parties.¹¹⁰ As with any contract, a derivative contract contains mutual promises, is subject to interpretation based on common law contract doctrine, and is legally enforceable.¹¹¹ If, in other contexts, a party's negotiation of and entering into a contract is not generally something that is subject to regulation, then it is not immediately apparent why negotiating and entering into a swap should be treated any differently. In short, a swap is simply a private matter between private parties and does not implicate assets or transactions beyond the contract's perimeter.¹¹²

Nevertheless, from an alternative perspective—the perspective of one who recalls the financial crisis's economic devastation, say—regulation of swaps seems appropriate and, indeed, long overdue.¹¹³ Yet if swaps are merely tailored, enforceable contracts between knowledgeable parties, how can it be that they are suitable regulatory subjects? The simple answer is that there is no limit to the amount of pretending that the world can do. The following excerpt from the final report of the U.S. Financial Crisis Inquiry Commission is illuminating:

[Credit default swaps] were essential to the creation of synthetic CDOs. These synthetic CDOs were merely bets on the performance of real mortgage-related securities. They amplified the losses from the collapse of the housing bubble by allowing multiple bets on the same securities and helped spread them throughout the financial

110. See Kevin A. Reiss, *Securities, in Developments in Banking Law: 2000*, 20 ANN. REV. BANKING L. 106, 108 (2001) (noting that “swaps are contracts negotiated between private parties”). That parties to swaps are “sophisticated” is product of that fact that, both prior to and after Dodd–Frank, swap participants have had to satisfy certain financial criteria. See Dodd–Frank Act, Pub. L. No. 111-203, § 723, 124 Stat. 1376, 1675 (2010) (codified as amended at 7 U.S.C. § 2(e) (2013)) (prohibiting persons “other than . . . eligible contract participant[s]” from entering into non-exchange-traded swaps); see also Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554-App. E, § 103, 114 Stat. 2763A-365, 2763A-377 (exempting from regulation swap participants who qualified as “eligible contract participants” and met certain other requirements); 17 C.F.R. § 35.2(a) (2010) (exempting from regulation swap participants who qualified as “eligible swap participants”).

111. See Mary Williams Walsh, *Detroit Wins Judge's Nod for Contract Settlement*, N.Y. TIMES DEALBOOK (Apr. 11, 2014, 10:50 AM), <http://dealbook.nytimes.com/2014/04/11/judge-approves-pact-to-end-detroit-swap-deal/> (“The United States Bankruptcy Code contains a ‘safe harbor’ for financial derivatives that says, in effect, that swaps and other such financial contracts remain fully enforceable, even in bankruptcy.”).

112. This conclusion does not change based on the consideration that commodity futures—which, like securities, are heavily regulated—are formally also contracts. See *supra* note 35 and accompanying text (describing commodity futures contracts). There are a number of important differences between commodity futures contracts and swaps, including that, unlike swaps, anyone—sophisticated or not—may enter into a futures contract, with the result that, for any particular contract, there may be substantial power imbalances between the parties. See GLOBAL DERIVATIVES STUDY GRP., GRP. OF THIRTY, DERIVATIVES: PRACTICES AND PRINCIPLES 32 (1993) (explaining that “futures contracts [are] accessible to members of the general public, including retail speculators”).

113. For a discussion of the role that swaps played during the financial crisis, see *supra* Part II.B.

system. Goldman Sachs alone packaged and sold \$73 billion in synthetic CDOs from July 1, 2004, to May 31, 2007. Synthetic CDOs created by Goldman referenced more than 3,400 mortgage securities, and 610 of them were referenced at least twice. This is apart from how many times these securities may have been referenced in synthetic CDOs created by other firms.¹¹⁴

Swaps, recall, are based on pretense—the pretense that a party to the contract has invested in a security, holds a short position as to the security, has borrowed or loaned a sum of money, or is a creditor potentially at risk of not being repaid.¹¹⁵ By contrast, investments are limited. At any given time, a public company may issue only so many shares of stock and has only so many shares outstanding (which, in turn, also sets a limit on the exercise of options or warrants as to those shares).¹¹⁶

Everyone, in theory, can pretend—many times over and in any magnitude. Accordingly, an adverse event as to the subjects of that pretending (the reference assets), such as defaults on mortgages that serve as the reference assets for credit default swaps or the bankruptcy of a large company whose stock is the reference asset for total return swaps, may have systemic consequences. That is particularly the case to the extent that the same contracting parties have disproportionately “pretended,” either by entering into many such contracts or by entering into contracts referring to assets with sizable notional values. Insofar as swaps present limitless exposure opportunities without corresponding safeguards, the rationale for regulation is clear.

D. TITLE VII OF DODD–FRANK

Dodd–Frank was Congress’s response to the financial crisis—its attempt to bolster the integrity and soundness of the financial markets and thereby forestall future crises.¹¹⁷ Given the legislation’s purpose, it is hardly surprising that it is far-reaching, touching virtually all components of the financial and capital markets. Its many sections pertain to corporate governance,¹¹⁸ credit-

114. INQUIRY REPORT, *supra* note 21, at xxiv–xxv.

115. See *supra* Part II.A.1 (discussing the ways in which transacting in swaps involves pretending).

116. A corporation, for example, cannot issue a greater number of shares than the amount authorized in its articles of incorporation. See, e.g., Mira Ganor, *The Power to Issue Stock*, 46 WAKE FOREST L. REV. 701, 733 (2011) (observing that a firm’s authorized capital, as set forth in its articles of incorporation, is the “upper limit on how many shares management can issue without the shareholders’ approval”).

117. The statute states its purpose in its preamble: “[T]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.” Dodd–Frank Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, 15 U.S.C.).

118. See, e.g., *id.* §§ 971–972 (“Strengthening Corporate Governance”).

rating services,¹¹⁹ banking and brokerage practices,¹²⁰ investment advisers and hedge funds,¹²¹ proprietary investing by financial institutions,¹²² consumer protection,¹²³ mortgage lending,¹²⁴ and more. Dodd–Frank also regulates swaps and the swap markets.¹²⁵

Prior to Dodd–Frank, swaps were not regulated—and that was not a matter of happenstance or oversight. Rather, it was an express product of congressional and regulatory action, embodied, most recently, in the Commodity Futures Modernization Act of 2000 (the “CFMA”).¹²⁶ That statute, which divided the regulatory terrain concerning financial instruments between the SEC and the CFTC,¹²⁷ prohibited either agency from regulating OTC derivatives, including swaps.¹²⁸ More specifically, it exempted from the coverage of the CEA—the statute that regulates commodity futures—individually-negotiated swaps referencing financial assets or non-agricultural commodities, such as energy and metals, entered into by parties qualifying as “eligible contract participants.”¹²⁹ In so doing, the CFMA excluded those swaps from CFTC’s regulatory authority.¹³⁰ Moreover, although the 2000 legislation placed oversight authority for security-based swaps with the SEC, it severely curtailed the reach of that authority.¹³¹

119. See, e.g., *id.* §§ 931–939 (“Improvements to the Regulation of Credit Rating Agencies”).

120. See, e.g., *id.* §§ 161–176 (“Additional Board of Governors Authority for Certain Nonbank Financial Companies and Bank Holding Companies”); *id.* tit. VI (“Improvements to Regulation of Bank and Savings Association Holding Companies and Depository Institutions”).

121. See, e.g., *id.* tit. IV (“Regulation of Advisers to Hedge Funds and Others”).

122. See, e.g., *id.* § 619 (“Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds”).

123. See, e.g., *id.* tit. X (“Bureau of Consumer Financial Protection”).

124. See, e.g., *id.* tit. XIV (“Mortgage Reform and Anti-Predatory Lending Act”).

125. See, e.g., *id.* tit. VII (“Wall Street Transparency and Accountability”).

126. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763A (2000) (codified as amended in scattered sections of 7, 11, 12, 15 U.S.C.).

127. See *id.* § 251(a)(2)(D)(i) (giving the SEC “jurisdiction and authority over” securities-related instruments).

128. See *id.* §§ 103, 107 (excluding OTC derivative transactions from the CEA’s coverage).

129. *Id.* § 103.

130. The CFMA also affirmed and preserved the CEA’s pre-emption of state anti-gambling and “bucket shop” laws that states otherwise may have enforced against these exempt instruments. See *id.* § 210 (specifying that the CEA preempts certain state laws).

131. See, e.g., *id.* § 202(a)(g)(1)(4) (exempting boards of trades registered with the CFTC from certain SEC rules in connection with their listing of security futures contracts). In mandating a hands-off regulatory policy toward swaps, the CFMA merely affirmed lawmakers’ long-existing sentiment against swap regulation. Almost ten years prior to the CFMA’s enactment, as swaps became ever more prevalent in the financial markets, Congress sought to ensure that courts could not declare swaps to be “illegal, off-exchange futures contract[s].” MARK JICKLING, CONG. RESEARCH SERV., CRS REPORT FOR CONGRESS: REGULATION OF ENERGY DERIVATIVES 3 (2006), available at http://assets.opencrs.com/rpts/RS21401_20060421.pdf. Specifically, in 1992, Congress enacted the Futures Trading Practices Act, which permitted the CFTC to expressly remove most types of swap transactions from the CEA’s purview. See Futures Trading Practices Act of 1992, Pub. L. No. 102-546, § 502, 106 Stat. 3590 (repealed 2000). The CFTC

That swaps were largely free of regulation meant that, when Congress faced its task of implementing a regulatory framework for swaps after the financial crisis, it was able to paint on a canvas that was relatively blank—but not completely. Both before and after Congress passed the CFMA, swaps were indirectly subject to regulatory oversight as a result of the fact that banking and brokerage institutions were primary swap counterparties.¹³² Both types of institutions are subject to extensive regulation—by the SEC and the Federal Reserve, respectively—which encompasses, for example, complying with net capital requirements based on their particular activities, including those pertaining to swaps.¹³³ Still, the pre-Dodd–Frank swap regulation was necessarily limited in scope and depth, as it was merely a by-product of regulatory regimes directed primarily at core areas unrelated to swaps.¹³⁴

Post-Dodd–Frank, swap regulation is decidedly not limited in scope. Before delving into the content of the new regulation, it is worth noting that the term “swaps,” for purposes of Title VII of Dodd–Frank and the agency rulemaking that implements it, does not encompass those swaps that are associated with the SEC’s traditional regulatory realm: securities. Dodd–Frank refers to those swaps as “security-based swaps,” which it further defines to encompass, for example, total return swaps that reference a single security or a narrowly based index of securities and credit default swaps referencing a single credit or a narrowly based index of securities.¹³⁵ The statute places security-based swaps within the SEC’s regulatory jurisdiction and places all

used that authority to exempt from regulation swaps and other OTC derivatives, on the basis that such instruments are individually negotiated by sophisticated parties, rather than standardized and accessible to the general public. See Commodity Futures Trading Commission Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694, 30,694–96 (July 21, 1989).

132. See Net Capital Rule, 58 Fed. Reg. 27,486, 27,487 (May 10, 1993) (to be codified at 17 C.F.R. pt. 240) (“Broker-dealers registered with the [SEC], or . . . affiliates of the broker-dealer, along with certain banks, principally serve as financial intermediaries in the OTC derivative products market, undertaking a dealer or market-making function.”); Roberta Romano, *A Thumbnail Sketch of Derivative Securities and Their Regulation*, 55 MD. L. REV. 1, 59 (1996) (“The major players in swaps are commercial banks, whose activities are heavily regulated by federal banking agencies.”).

133. See Romano, *supra* note 132, at 59 (“Banking regulators use three principal tools of control: examinations, reporting requirements, and capital requirements.”).

134. See Desmond Eppel, Note, *Risky Business: Responding to OTC Derivative Crises*, 40 COLUM. J. TRANSNAT’L L. 677, 680 (2002) (noting that “[b]anking regulators indirectly regulate the swaps market”).

135. See Dodd–Frank Act, Pub. L. No. 111-203, § 761(a)(6), 124 Stat. 1376, 1755–56 (2010) (codified as amended at 15 U.S.C. § 78c(a)(68) (2012)) (defining “security-based swap”). Accordingly, within the CFTC’s purview are such instruments as swaps referencing commodities, weather, energy, and emissions, as well as interest-rate and foreign-exchange swaps and a variety of other swaps that do not seem to fit comfortably within the aegis of either agency. See *id.* § 721(a)(21) (codified as amended at 7 U.S.C. § 1a(47)(A)) (defining “swap”). There are also creatures labeled “mixed swaps,” which have characteristics of both swaps and security-based swaps. See *id.* (codified as amended at 7 U.S.C. § 1a(47)(D)) (defining “mixed swap”).

other swaps (those not qualifying as security-based swaps) under the CFTC's jurisdiction.¹³⁶

In light of this demarcation between swaps relating to securities, on the one hand, and all other swaps, on the other, Title VII is essentially bifurcated, with some provisions applicable to swaps and those who transact in them and other provisions applicable to security-based swaps and those transacting in them. Just as Dodd–Frank sets forth regulatory obligations for firms meeting the definition of swap dealer,¹³⁷ then, it also sets out separate (but largely identical) obligations for firms falling within the definition of security-based swap dealer.¹³⁸ Nevertheless, security-based swaps comprise only a small portion of all swaps.¹³⁹ In addition, the CFTC has been considerably more active than the SEC in proposing and finalizing rules under Title VII.¹⁴⁰ Accordingly, this Article focuses only on Title VII's provisions that relate to swaps (rather than security-based swaps) and the CFTC's rules pertaining to them.

Although Title VII's many provisions cover almost as many discrete topics, the new regulatory world for swaps consists of four primary components. The first is a requirement that swap participants meeting the definition of “swap dealer” or “major swap participant” register with the CFTC as such and comply with the particular (and extensive) requirements that apply to swap dealers or major swap participants; as the case may be.¹⁴¹ As Part III explains in more detail, swap dealers are, in essence, persons who hold themselves out as parties willing to enter into swaps as principal—that is, on their own behalf (“for [their] own account”), rather than in an agency capacity, acting merely as middlemen.¹⁴² Not encompassed by the term “swap

136. See *id.* § 712(b)(1)–(2) (confirming that the CFTC has no jurisdiction over security-based swaps and security-based swap dealers and that the SEC has no jurisdiction over swaps and swap dealers).

137. See *id.* §§ 721–754 (codified as amended at scattered sections of 7 U.S.C.) (pertaining to regulation of the swap markets).

138. See *id.* §§ 761–774 (codified as amended at scattered sections of 15 U.S.C.) (pertaining to regulation of the securities-based swap markets).

139. See Roberta Rampton, *CFTC's O'Malia Opens Door to More Swaps Trade Debate*, REUTERS (Mar. 15, 2011, 8:00 AM) (“The Dodd–Frank law gave the CFTC jurisdiction over most of the over-the-counter swaps market, although the [SEC] has oversight of a small slice related to securities-based swaps.”).

140. See Annette L. Nazareth & Gabriel D. Rosenberg, *The New Regulation of Swaps: A Lost Opportunity*, 55 COMP. ECON. STUD. 535, 546 (2013) (noting that, from the time Dodd–Frank was enacted to April 2011, the SEC proposed and adopted 12 rules under Title VII, while the CFTC proposed and adopted 49).

141. See Dodd–Frank Act § 731 (codified at 7 U.S.C. § 6s) (requiring registration and regulation of firms falling within the definition of “swap dealer” or “major swap participant”). For a listing of some of the substantive obligations to which swap dealers, as well as major swap participants, are subject, see *infra* notes 309–16 and accompanying text.

142. See *infra* notes 160–61 and accompanying text (discussing Dodd–Frank's definition of “swap dealer”).

dealer,” as Title VII very generally defines it, is anyone who, though entering into swaps for its own account, nonetheless does not do so “as part of a regular business.”¹⁴³ For its part, Title VII defines “major swap participant” to encompass persons whose transactions in swaps are substantial but who cannot be considered swap dealers.¹⁴⁴ Although the statute broadly defines what types of persons qualify as swap dealers or major swap participants, it leaves to the CFTC the work of defining the terms used in those definitions.¹⁴⁵ As Part III shows, the agencies’ efforts on this front have substantively shaped the scope of the new regulation of the swap industry.

A second important component of Dodd–Frank’s swap regulation is the requirement that most swaps be submitted to a registered “derivatives clearing organization” (“DCO”).¹⁴⁶ In essence, as a result of that provision, parties must execute swaps through so-called clearinghouses, which stand between the parties, effectively acting as the counterparty to each.¹⁴⁷ As for which swaps must be cleared, that determination is left to the CFTC, which must review swaps or categories of swaps that a DCO claims it is prepared to clear.¹⁴⁸ In its review, the CFTC must consider a number of specific factors, including the effect that clearing the swap might have on systemic risk mitigation and whether the DCO has the resources and capacity to clear the swap.¹⁴⁹

Third, in connection with the clearing requirement, Dodd–Frank instructs the CFTC to adopt rules requiring a DCO to report to the CFTC any

143. Dodd–Frank Act § 721(a)(21) (codified as amended at 7 U.S.C. § 1a(49)) (defining “swap dealer”).

144. *Id.* § 721(a)(16) (codified as amended at 7 U.S.C. § 1a(33)) (defining “major swap participant”).

145. *See id.* § 721(c) (codified as amended at 15 U.S.C. § 8321) (authorizing the CFTC to adopt rules further defining the terms “swap,” “swap dealer,” and “major swap participant”). Similarly, Dodd–Frank authorizes the SEC to adopt rules further defining the terms “security-based swap,” “security-based swap dealer,” and “major security-based swap participant.” *See id.* § 761(a)(6) (codified as amended at 15 U.S.C. § 78c(a)).

146. *See id.* § 723(a)(2) (codified as amended at 7 U.S.C. § 2(h)(1)) (providing that, unless an exemption applies, it is unlawful to enter into a swap unless the swap is submitted to a DCO).

147. Each counterparty periodically deposits with the clearinghouse sufficient funds to cover amounts that it would owe to its counterparty if the swap were settled at that time. *See* Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivatives Clearinghouses*, 61 EMORY L.J. 1153, 1155–56 (2012) (explaining the purpose of the clearing requirement). Although Congress imposed the clearing requirement so that “the consequences of [a counterparty’s] default will . . . not spread throughout the broader financial system,” *id.* at 1156, some observers have questioned its efficacy. *See, e.g.,* Mark J. Roe, *Clearinghouse Overconfidence*, 101 CALIF. L. REV. 1641, 1644 (2013) (“[C]learinghouses can only marginally lower systemic risk.”); Yesha Yadav, *The Problematic Case of Clearinghouses in Complex Markets*, 101 GEO. L.J. 387, 393 (2013) (arguing that the “distorted incentives” of those who use clearinghouses “can . . . lead to behavior that increases the chances that the clearinghouse itself descends into crisis”).

148. *See* Dodd–Frank Act § 723(a)(2) (codified as amended at 7 U.S.C. § 2(h)(2)(A)(i)) (requiring the CFTC, on an ongoing basis, to review swaps or categories of swaps that DCOs list for clearing).

149. *See id.* (codified as amended at 7 U.S.C. § 2(h)(2)(D)) (setting forth the factors the CFTC must consider in conducting its review).

swap that it clears as soon as practicable after executing the transaction¹⁵⁰ and to make the reported information publicly available.¹⁵¹ Swaps that are not subject to mandatory clearing must likewise be reported to the CFTC (predictably, without the assistance of a DCO) or to a registered “swap data repository,”¹⁵² although that reporting is not subject to a public disclosure requirement. If one of the parties to an uncleared swap is a swap dealer or major swap participant, that party has the reporting obligation, with the former having the obligation if one party is a swap dealer and the other is a major swap participant.¹⁵³

The fourth and final core component of Dodd–Frank’s swaps regulation is formulated as a prohibition and, at first glance, does not seem particularly important or interesting. Specifically, consistent with principles of international comity, section 722 (d) cautions that neither the statute nor any rule that an agency might adopt pursuant to authority granted by the statute will apply to activities outside the United States, unless those activities “have a direct and significant connection with activities in, or effect on, commerce of the United States.”¹⁵⁴ This provision—only one sentence long—is tucked away amidst some of Title VII’s more attention-grabbing and substantive provisions. As Part III contends, however, as a result of the CFTC’s interpretation of the provision, it has become perhaps the most complex and controversial component of the new swap regulatory regime—as well as the most problematic.¹⁵⁵

150. *See id.* §§ 725(e), 727 (codified as amended at 7 U.S.C. §§ 72a-1(k), -2(a)(13)) (requiring DCOs to report to the CFTC swaps that they clear in accordance with the rules adopted by the CFTC governing public swap data reporting).

151. *See id.* § 725(6) (codified as amended at 7 U.S.C. § 72a-1(c)) (requiring public disclosure of cleared transactions).

152. *See id.* § 729 (codified as amended at 7 U.S.C. § 6r(a)) (requiring the reporting of uncleared swaps).

153. *See id.* (codified as amended at 7 U.S.C. § 6r(a)(3)) (specifying which parties have reporting obligations relating to uncleared swaps). If neither party is a swap dealer or a major swap participant, the parties must agree between themselves which one will report the transaction. *See id.* (codified as amended at 7 U.S.C. § 6r(a)(3)(C)).

154. *See id.* § 722(d) (codified as amended at 7 U.S.C. § 2(i)) (setting forth extraterritorial limitations of Dodd–Frank’s swap-related provisions).

155. *See infra* Part III.B. Title VII contains many additional provisions (beyond those discussed in this section). Among them, for example, are provisions prohibiting large (as determined by the CFTC) trades in swaps that the CFTC determines to serve “a significant price discovery function with respect to” public companies, Dodd–Frank Act § 730 (codified as amended at 7 U.S.C. § 6t(a)(1)), and requiring firms that execute swap transactions—that is, who act as an intermediary between a swap counterparty and a DCO—to be registered with the CFTC as either a “swap execution facility” or as a DCO and to comply with various reporting, recordkeeping, and monitoring requirements, *see id.* § 733 (codified as amended at 7 U.S.C. § 7b-3) (setting forth the regulation of swap execution facilities).

III. THE SWAP RULES

Dodd–Frank’s swap regulation, comprehensive though it may be, is also skeletal. Many of the requirements take the form of directions to the CFTC to adopt rules to elaborate on and implement various broadly articulated subjects.¹⁵⁶ Thus, although Title VII has been the subject of extensive commentary and analysis, it does not—indeed, cannot—on its own illuminate life in the new regulatory world, for it left to the CFTC the task of constructing much of that world. Following Congress’s instructions, the CFTC has devoted substantial energy in the years since Dodd–Frank’s completion to implement Title VII’s provisions through its rulemaking process.¹⁵⁷ Yet, unlike Title VII itself, these new rules have garnered very little attention in the press—apart from that associated with sporadic accolades to the CFTC for (apparently) its sheer prolificacy—and virtually no attention in the academy.¹⁵⁸ As a result, there has been very little focus on how the rules undercut Congress’s post-financial crisis regulatory objectives.

This Part evaluates two significant groups of the CFTC’s swap rules, showing that, although the agency’s task was to refine and elaborate Title VII, the rules nonetheless set in place a regulatory regime that is arguably at odds with Congress’s vision for swap regulation. Subpart A focuses on the rules determining whether a person is a swap dealer and, therefore, subject to regulation as such, while Subpart B evaluates the rules governing Title VII’s extraterritorial application and their implications for well-functioning and efficient swap markets. The analyses show how these rules reflect the CFTC’s own regulatory vision—one that, grounded in the pretending that all swaps involve, ignores the greater importance of the similarities between investing and pretending.

156. See, e.g., Dodd–Frank Act § 723(a)(3) (codified as amended at 7 U.S.C. § 2(h)(2)(E)) (mandating rules governing a DCO’s submission, for CFTC review, a swap that it seeks to accept for clearing); *id.* § 726(b) (codified as amended at 15 U.S.C. § 8323(b)) (mandating rules designed to mitigate conflicts of interest of DCOs, swap execution facilities, and others); *id.* § 727 (codified as amended at 7 U.S.C. § 2(a)(13)(C)) (mandating rules governing the public availability of swap transaction and pricing data); *id.* § 731 (codified as amended at 7 U.S.C. § 6s(d)) (mandating rules governing swap dealers and major swap participants).

157. So far, the CFTC has produced dozens of rules and thousands of pages describing the rationale behind them. See Jeff Mason & Alina Selyukh, *Update 2-Obama Nominates Senate Aide for FCC Republican Commissioner*, REUTERS (Aug. 2, 2013, 2:31 AM), <http://uk.reuters.com/article/2013/08/02/obama-cftc-fcc-idUKL1NoG22PK20130802> (reporting that the CFTC “has been writing scores of new rules to change the structure of the opaque [swap] market”).

158. For example, Joe Nocera of the *New York Times* lauded then-CFTC chairman Gary Gensler’s performance based, in part, on Mr. Gensler’s having overseen the CFTC’s adoption of “dozens of rules to regulate derivatives” pursuant to Dodd–Frank’s requirements. Joe Nocera, Op-Ed., *The Little Agency That Could*, N.Y. TIMES (Nov. 15, 2013), <http://www.nytimes.com/2013/11/16/opinion/the-little-agency-that-could.html>. Although Mr. Nocera claimed that the rules both made the swap markets more transparent and “lower[ed] prices,” he did not describe any of the rules or how they accomplish the feats he identifies. See *id.*

A. THE SWAP DEALER RULES

As Part II discusses, Dodd–Frank creates a new category of regulated persons—swap dealers—based on those persons’ activities dealing in swaps.¹⁵⁹ In particular, Dodd–Frank defines the term “swap dealer” to mean one that “holds itself out as a dealer in swaps,” is a market-maker in swaps, “regularly enters into swaps . . . as an ordinary course of business for its own account,” or pursues activities that cause it to be known in the trade as a swap dealer or market-maker.¹⁶⁰ The statute also expressly excludes as a swap dealer one who enters into swaps for its own account “but not as a part of a regular course of business.”¹⁶¹ However, the statute left many blanks in the swap dealer definition, directing the CFTC, jointly with the SEC,¹⁶² to fill them in.¹⁶³ As this Subpart shows, the agencies filled in the blanks, in a set of rules and interpretations, in such a way as to extend swap dealer regulation beyond the boundaries that Congress likely intended—and beyond the realm of sensible regulation.

In defining what a swap dealer is, the agencies promulgated both (1) rules excluding certain swaps from consideration in determining whether a person falls within the definition;¹⁶⁴ and (2) interpretive guidance outlining what types of activities might cause one to fall within any of the four prongs of the swap dealer definition, noted above (collectively, the “swap dealer

159. Although Dodd–Frank and the swap rules generally subject swap dealers and major swap participants to the same requirements, see Dodd–Frank Act § 731 (codified as amended at 7 U.S.C. § 6s) (setting forth requirements to which swap dealers and major swap participants will be subject), this Article focuses only on the former. As noted in Part II, the “major swap participant” category is intended to capture swap participants that are not swap dealers but that nonetheless engage in significant swap-market activity. See *supra* note 144 and accompanying text. The swap rules’ application to major swap participants raises similar concerns to those raised in the swap dealer context, which this Subpart describes. However, in light of the CFTC’s further elaboration of Dodd–Frank’s definition of “major swap participant,” informed observers believe that very few swap participants will be required to be regulated as such, with the CFTC estimating that approximately six participants in the United States will be captured by the definition at any given time. See Matt Cameron & Joe Rennison, *Zombie Firms Are First Dodd–Frank Major Swap Participants*, RISK MAG. (Mar. 7, 2013), <http://www.risk.net/risk-magazine/news/2252713/zombie-firms-are-first-doddfrank-major-swap-participants> (“The [CFTC] estimated last year that up to six derivatives users would fall into the MSP category.”).

160. Dodd–Frank Act § 721 (a) (codified as amended at 7 U.S.C. § 1a(49)) (defining “swap dealer”).

161. *Id.*

162. Although the rules pertaining to the meaning of “swap dealer” are formally the joint product of the CFTC and the SEC, it is apparent—and not surprising, given Dodd–Frank’s bifurcated approach to swap regulation, see *supra* notes 135–38 and accompanying text—that the CFTC was the dominant force in formulating the rules.

163. See Dodd–Frank Act § 712(d)(1) (codified as amended at 15 U.S.C. § 8302) (providing that the CFTC and the SEC “shall further define the terms ‘swap’, ‘security-based swap’, ‘swap dealer’”).

164. See 17 C.F.R. § 1.3(ggg)(5)–(6) (2014).

rules”).¹⁶⁵ Perhaps the most important of the exclusions is a *de minimis* provision, as mandated by Dodd–Frank,¹⁶⁶ providing that, if the aggregate notional value of a person’s swap transactions over the previous 12 months did not exceed a threshold amount, the person need not register as a swap dealer, even if the person otherwise falls within the definition.¹⁶⁷ The remaining exclusions provide that swaps that a firm might enter into with its majority-owned affiliates,¹⁶⁸ swaps entered into by a cooperative with a member of the cooperative,¹⁶⁹ swaps that an individual enters into as a trader on the floor of an exchange,¹⁷⁰ and, as discussed below, swaps that a firm uses to hedge physical positions that it actually holds¹⁷¹ need not be taken into account for purposes of determining swap dealer status. The guidance, for its part, lists various identifying characteristics of swap dealers, including that they make themselves available to enter into swaps, enter into swaps on their own standard terms, can create new kinds of swaps, often have regular clientele, and seek new clients pursuing swap activities.¹⁷²

Taken together, the exclusions and the guidance are ill-suited to capture those who should arguably be regulated as swap dealers, while excluding those who should not. The difficulties are first evident in the agencies’ front-and-center discussion of how the “dealer–trader” distinction—a longstanding tool in the securities context to separate those who fall within the Exchange Act’s definition of “dealer” from those who are merely traders or hedgers¹⁷³—is also “an appropriate framework for interpreting the statutory definition of the term ‘swap dealer.’”¹⁷⁴ In this discussion, the agencies point to various activities that, in their view, not only indicate dealing activity for purposes of the Exchange Act but also suggest that a person is “acting as a swap dealer.”¹⁷⁵ Among these activities are providing liquidity by being available to do so; advising counterparties regarding the use of swaps to meet the counterparties’

165. See Swap Dealer Release, 77 Fed. Reg. 30,596, 30,596–616 (May 23, 2012) (setting forth the CFTC and SEC’s final rules and interpretive guidance relating to the definition of swap dealer).

166. See Dodd–Frank Act § 721(a)(49)(D) (codified as amended at 7 U.S.C. § 1a(49)(D)) (“The [CFTC] shall exempt from designation as a swap dealer an entity that engages in a *de minimis* quantity of swap dealing in connection with transactions with or on behalf of its customers.”).

167. See 17 C.F.R. § 1.3(ggg)(4).

168. See *id.* § 1.3(ggg)(6)(i).

169. See *id.* § 1.3(ggg)(6)(ii).

170. See *id.* § 1.3(ggg)(6)(iv).

171. See *id.* § 1.3(ggg)(6)(iii); see also *infra* notes 188–94 and accompanying text.

172. See Swap Dealer Release, 77 Fed. Reg. 30,596, 30,606–16 (May 23, 2012) (setting forth the agencies’ interpretive guidance).

173. See Definition of Terms and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, 68 Fed. Reg. 8686, 8688 (Feb. 24, 2003) (“The dealer/trader distinction recognizes that dealers normally have a regular clientele, hold themselves out as buying or selling securities at a regular place of business, have a regular turnover of inventory . . . and generally provide liquidity services.”).

174. Swap Dealer Release, 77 Fed. Reg. at 30,607.

175. *Id.*

hedging needs; having “regular clientele”; acting as a market maker in swaps; and “helping to set the prices offered in the swap market.”¹⁷⁶

To the extent that one might take comfort from the clarity of this distinction, however, that comfort is short-lived. Despite embracing the dealer–trader distinction, the agencies caution that the activities indicating dealer status, “though instructive, may be inapplicable to swaps in certain circumstances or may be applied differently in the context of dealing activities involving commodity, interest rate, or other types of swaps.”¹⁷⁷ From there, the agencies proceed to list a number of differences between the securities and the swap contexts and explain how those differences affect the application of the dealer–trader distinction to swap market activity. For example, the predominance of non-standardized instruments in the swap markets “suggest[s] that concepts of what it means to make a market need to be construed flexibly in the contexts of the swap markets,” and the fact that “[s]wap markets are marked by less activity than [securities markets] . . . suggests that in the swap context, concepts of ‘regularity’ should account for a participant’s level of activity in the market relative to the total size of the market.”¹⁷⁸ Indeed, according to the agencies, determining whether a person is a swap dealer will depend on all relevant facts and circumstances.¹⁷⁹ Ultimately, then, the agencies’ extensive curtailment of the dealer–trader distinction in the swap context defeats the purpose of the analogy. Despite the familiarity of the distinction among market participants and despite the agencies’ emphasis on its usefulness, it arguably does nothing to clarify who is and who is not a swap dealer.

Beyond providing general guidance concerning what activities are “dealing activities,” the agencies address certain prongs of the swap dealer definition.¹⁸⁰ For example, recall that, under Dodd–Frank’s definition of swap dealer, a person is a swap dealer if it holds itself out as a dealer in swaps or engages in activities that cause itself to be known in the trade as a dealer or market maker in swaps.¹⁸¹ In seeking to assure end users that their sporadic activities of seeking out swap counterparties and developing new types of swaps (a role that dealers typically perform) will not, without more, cause

176. *Id.*

177. *Id.* at 30,606. As CFTC Commissioner Scott D. O’Malia observed in his dissent to the swap dealer rules, “for all of its girth, the CFTC [Swap Dealer Release] fails to answer a basic question—namely, under which circumstances would an entity be deemed a dealer (rather than a trader or hedger) with respect to specific swap transactions?” *Id.* at 30,761 (dissenting statement of Comm’r Scott D. O’Malia).

178. *Id.* at 30,607.

179. *See id.* at 30,608 (“[W]hether a person is acting as a dealer will turn upon the relevant facts and circumstances.”).

180. *See id.* at 30,608–10 (providing guidance as to the “holding oneself out as a dealer” and the “market maker” prongs of the swap dealer definition).

181. *See supra* notes 160–61 and accompanying text (setting forth the definition of swap dealer under Dodd–Frank).

them to be considered swap dealers, the agencies provide only watered-down relief. “[T]hese end users *do not necessarily* fall within the definition of a swap dealer,” they opine—for the determination will depend on “applicable facts and circumstances.”¹⁸² Similar uncertainties emerge from the agencies’ discussions of—or failure to discuss—other prongs of the definition.¹⁸³

Perhaps as important as the prongs of Dodd–Frank’s swap dealer definition is the statute’s express exception for those who do not engage in swap activities as part of a “regular business.”¹⁸⁴ Here, too, the agencies provide interpretive guidance, listing a number of indicators of a person’s having a regular business of entering into swaps.¹⁸⁵ These indicators include “[e]ntering into swaps [to] satisf[y] the business or risk management needs of the counterparty” and maintaining “staff and resources allocated to dealer-type activities with counterparties.”¹⁸⁶ However, here, too, market participants must consider all of the facts and circumstances in determining whether the exception applies, as the agencies decline to provide sharply defined criteria for the “regular business” analysis. Because Dodd–Frank’s requirements and “other forces” will cause transacting in swaps and the functioning of the swap markets to evolve over time, the agencies observe, “it would be inappropriate to craft *per se* exclusions from the swap dealer definition.”¹⁸⁷

182. Swap Dealer Release, 77 Fed. Reg. at 30,609 (emphasis added). The agencies also note that the factors they provided “as indicia of holding oneself out as a swap dealer” should “be considered in the context of all the activities of the swap participant,” and “they are not *per se* conclusive, and could be countered by other factors indicating that the person is not a swap dealer.” *Id.*

183. See, e.g., Peter Madigan, *The Club No-One Wants to Join: Swap Dealer Rules Remain Unclear*, RISK MAG. (June 1, 2012), <http://www.risk.net/risk-magazine/feature/2175980/club-join-swap-dealer-rules-remain-unclear> (reporting concerns arising from the fact that the CFTC did not define “regularly” in the third prong of the swap dealer definition); *id.* (reporting concerns that, although the CFTC uses “occasionally” and “continuously” to elucidate the meaning of “routinely” in the second prong of the swap dealer definition, it did not define those words).

184. Dodd–Frank Act, Pub. L. No. 11-203, § 721(a), 124 Stat. 1376, 1658 (2010) (codified as amended at 7 U.S.C. § 1a(49) (2012)). One curious aspect of the agencies’ interpretation of this exclusion is that they regard “as essentially synonymous” the phrases, “ordinary course of business,” as used in the swap dealer definition, and “regular business,” as used in the exclusion to the swap dealer definition. Swap Dealer Release, 77 Fed. Reg. at 30,610 (internal quotation marks omitted). That the phrase “ordinary course of business” appears in only one of the swap dealer definition prongs—a swap dealer is one who “regularly enters into swaps with counterparties as an ordinary course of business for its own account”—raises a question as to why, if the phrases are intended to have the same meaning, Congress’s one exclusion from the swap dealer definition refers to only a single prong of the multi-part definition and effectively says the same thing as that prong. *Id.* at 30,759 (dissenting statement of Comm’r Scott D. O’Malia) (internal quotation marks omitted) (arguing that the two phrases have to mean different things based on canons of statutory construction and indications of Congress’s intent); see also Dodd–Frank Act § 721(a) (codified as amended at 7 U.S.C. § 1a(49)).

185. See Swap Dealer Release, 77 Fed. Reg. at 30,610–11.

186. *Id.* at 30,610.

187. *Id.* at 30,611.

Finally, as noted above, the agencies included in the swap dealer rules an exclusion pursuant to which swaps that a person uses to hedge physical positions that the person actually holds—for example, assets that the firm owns or produces, liabilities that it has incurred, or services that it provides—are not to be considered for purposes of determining whether the person is a swap dealer.¹⁸⁸ Thanks to that exclusion, then, entering into swaps to hedge physical positions is “activity that will not be considered swap dealing activity.”¹⁸⁹ The exclusion makes sense, as far as it goes, since both Congress and the agencies have recognized that entering into swaps for hedging purposes is inconsistent with swap dealing, which generally is an activity involving serving *others’* swap-related needs.¹⁹⁰ That apparent logic, however, highlights the difficulty with the exclusion. By failing to exclude from consideration all swaps entered into to hedge or mitigate commercial risk (including those that hedge market risk or general economic risk, for example), the agencies contemplate that, in at least some circumstances, entering into swaps for hedging purposes constitutes swap-dealing activity.¹⁹¹ That result, in turn, produces the conclusion that the agencies contemplate that at least some firms who use swaps solely to hedge commercial risks (other than those associated with physical positions) could be legitimately regulated as swap dealers, despite Congress’s apparent conclusion to the contrary.

The result is all the more troublesome given the rationale the agencies provide to justify it. In particular, the agencies’ reluctance to exclude all swaps used to hedge commercial risk stems from the possibility that a firm may enter into swaps “for the purpose of accommodating the counterparty’s needs” or otherwise in a manner “constitut[ing] swap dealing activity,” even though the swaps also happen to have a “hedging consequence” for the firm.¹⁹² The agencies suggest that those sorts of swaps should not be excluded from consideration in determining swap dealer status.¹⁹³ However, it is difficult to

188. See 17 C.F.R. § 1.3(ggg)(6)(iii) (2014).

189. Swap Dealer Release, 77 Fed. Reg. at 30,613. That is not to say that other swaps that mitigate commercial risk other than risks arising from physical positions will necessarily be considered “swap dealing activity.” Rather, according to the agencies, “such [other] hedging activity is to be considered in light of all other relevant facts and circumstances to determine whether the person is engaging in activity (e.g., accommodating demand for swaps, making a market for swaps, etc.) that makes the person a swap dealer.” *Id.*

190. See *id.* at 30,611 (“In general, entering into a swap for the purpose of hedging is inconsistent with swap dealing.”); see also *infra* note 195 and accompanying text (discussing the views of various Senate leaders that end users should not be subject to regulation as swap dealers).

191. The agencies expressly state as much. See Swap Dealer Release, 77 Fed. Reg. at 30,611 n.213 (“The absence of any explicit requirement in the ‘swap dealer’ definition to exclude swaps held for hedging or mitigating commercial risk does not support the view that Congress intended to categorically exclude all swaps that may serve as hedges in determining whether a person is covered by the definition.”).

192. *Id.* at 30,613.

193. See *id.* (noting that there is no way to distinguish between those swaps and swaps entered into for the purpose of hedging risk).

see how a broader exclusion—one that excludes all hedging activity—would encompass them, given another of the agencies' guidelines: "The exclusions . . . depend not on the effect or consequences of the swap but on whether the *purpose* for which a person enters into a swap is to hedge"¹⁹⁴ Under this guidance, if a firm enters into a swap for the purpose—or even only partially for the purpose—of accommodating another market participant's needs or demands, there should be little doubt that the swap would not fall within the exclusion, even if it served a hedging function for the firm.

Because the swap dealer rules do not commit firmly to basing swap dealer status on particular, readily identifiable factors, certain firms whose activities fall outside of Congress's conception of what a swap dealer is may become subject to regulation as such, so long as their swap activities are more than *de minimis*, and they do not limit their activities to hedging physical positions or engaging in certain other transactions that need not be considered in determining swap dealer status.¹⁹⁵ These firms, of course, are the classic end users, who rely on swaps solely to manage (hedge) certain risks associated with their business operations. Such firms neither hold themselves out as willing to deal in swaps nor do they have clients expecting them to do so, nor do they enter into swaps as a regular business.¹⁹⁶ Moreover, although regulatory safe harbors are most important in contexts in which facts-and-circumstances evaluations determine whether or not regulation applies, the agencies also declined to construct such a comfort zone—or, at least, they declined to construct one that extends as far as it needs to extend.¹⁹⁷

194. *Id.* (emphasis added).

195. Although discerning "congressional intent" is possibly a futile exercise, there are indications that those members who were most instrumental in drafting Title VII did not intend for swap dealer regulation to capture end users. *See, e.g.*, Letter from Christopher Dodd, Chairman, U.S. Senate Comm. on Banking, Hous., & Urban Affairs, & Blanche Lincoln, Chairwoman, U.S. Senate Comm. on Agric., Nutrition, & Forestry, to Barney Frank, Chairman, U.S. House Fin. Servs. Comm., & Colin Peterson, Chairman, U.S. House Comm. on Agric. (June 30, 2010), available at <https://www.reit.com/sites/default/files/portals/o/2011JointEnd-UserMarginLetter.pdf> ("Congress does not intend to regulate end-users as Major Swap Participants or Swap Dealers just because they use swaps to hedge or manage the commercial risks."); Letter from Debbie Stabenow, Chairwoman, U.S. Senate Comm. on Agric., Nutrition, & Forestry, & Frank D. Lucas, Chairman, U.S. House Comm. on Agric., to the Hon. Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n (Mar. 29, 2012) (urging the CFTC "to finalize the swap dealer definition in a manner that . . . will not impose significant new regulations on entities Congress did not intend to be regulated as swap dealers" such as end users who use swaps to hedge commercial risk).

196. In his dissent to the final rules regarding the swap dealer and other definitions, Commissioner O'Malia voiced similar concerns, noting that the CFTC "essentially used the 'swap dealer' definition to capture commercial end-users," even though "Congress clearly precluded this result." Swap Dealer Release, 77 Fed. Reg. at 30,759 (dissenting statement of Comm'r Scott D. O'Malia).

197. That is, the exclusion for swaps entered into to hedge physical positions could be viewed as a (narrow) safe harbor.

These concerns are far more than theoretical. During the comment period for the swap dealer rules, for example, numerous firms—end users—expressed their concerns that they would be considered swap dealers. Among others, energy and food production companies that engaged in substantial swap activities worried that those activities might be sufficiently extensive to cause them to surpass the agencies' *de minimis* threshold.¹⁹⁸ For a firm caught within the definition of swap dealer, moreover, the burdens of regulation as a swap dealer are more than a small inconvenience, given the complex and numerous regulatory requirements with which swap dealers must comply.¹⁹⁹ In light of these concerns, the swap dealer rules could deter firms that would otherwise use swaps from relying on them for risk-mitigation purposes—particularly firms that are unable, based on the rules, to obtain complete comfort that they are beyond regulation's purview.²⁰⁰

The prospect that end users could be deemed swap dealers under the agencies' newly elaborated definition seems wholly inappropriate from yet another perspective—namely, the rationale underlying Dodd–Frank. As an initial matter, end users' primary business activities are typically not related to the financial markets but, instead, are centered on manufacturing, production, and other “Main Street” endeavors.²⁰¹ These firms, therefore, arguably were not part of the cause of the financial crisis and did not benefit

198. See Swap Dealer Release, 77 Fed. Reg. at 30,760 (dissenting statement of Comm'r Scott D. O'Malia) (observing that various energy and production companies “took the time to draft and submit comment letters to the [CFTC] . . . because they were afraid of being defined as ‘swap dealers’”); see also Alexander Osipovich, *The Long and Winding Road to Dodd-Frank*, ENERGY RISK (Mar. 28, 2012), <http://www.risk.net/energy-risk/feature/2164239/winding-road-dodd-frank> (noting that, in light of the swap dealer rules, many energy companies are uncertain as to whether they are swap dealers).

199. See Madigan, *supra* note 183 (“Getting [the swap dealer definition] right is important because something in the order of 1500 different regulatory requirements emanate from the application of the swap dealer definition.” (quoting Luke Zubrod, director of the government and regulatory advisory at Pennsylvania-based interest rate and currency risk adviser Chatham Financial) (internal quotation marks omitted)).

200. Some firms that submitted comment letters to the CFTC expressed this concern, noting that uncertainty surrounding whether firms are swap dealers would cause end users to avoid using swaps altogether. See, e.g., Letter from Walter L. Hawkins, Jr., Senior Vice President, Peabody Energy Corp., to David A. Stawick, Secretary, Commodity Futures Trading Comm'n, and Elizabeth M. Murphy, Secretary, Sec. & Exch. Comm'n (Feb. 22, 2011), available at <http://www.sec.gov/comments/s7-39-10/s73910-57.pdf>. According to some, that result could, in turn, expose businesses to market volatility, to the detriment of consumers. See Bachus Letter, *supra* note 30, at 2 (contending that, if a too-broad definition of “swap dealer” drives end users from the swap market, those businesses would become “exposed to market volatility and the consequences will ultimately be felt by Americans in the form of increased consumer costs”).

201. Cf. Swap Dealer Release, 77 Fed. Reg. at 30,760 (dissenting statement of Comm'r Scott D. O'Malia) (observing that “commercial end-users include Caterpillar, John Deere, and ConAgra Foods,” which “have a regular business of supplying energy, food, and other tangible products to America” (internal quotations omitted)).

from the market conditions that spawned it.²⁰² Rather, like so many others, they were only harmed by it. Dodd–Frank reflects that fact, aiming its regulatory fixes at those whose activities contributed most directly to the crisis—namely, financial market professionals.²⁰³ The expansive swap dealer rules upend that logic.

The rules' inconsistency with the objectives behind Dodd–Frank is evident as well in Dodd–Frank's exclusion from the requirement that swap transactions be cleared through a DCO. In particular, the statute expressly exempts from the clearing requirement (and, therefore, the associated public disclosure requirement) swaps entered into for hedging purposes by firms that both use swaps only to mitigate commercial risk and are not "financial entities," a term that the statute defines to include financial institutions such as broker–dealers, investment advisers, hedge funds, and banks—as well as swap dealers.²⁰⁴ The "financial entity" definition, combined with the agencies' rules, produces the anomalous result that an end user that uses swaps solely to hedge business risks but that, for example, does so to an extent exceeding the *de minimis* threshold may, by being deemed a swap dealer, also be deemed a financial entity—a designation that deprives the firm of reliance on the clearing exemption for end users.²⁰⁵ That prospect is all the more illogical in light of the agencies' claim that, in general, hedging activity and swap dealing activity are mutually exclusive.²⁰⁶

Finally, the agencies' approach to the swap dealer definition departs from past regulatory approaches in the securities and commodity futures contexts. The statutes, rules, and regulatory interpretations in those contexts have, by-and-large, made fairly clear what types of persons are subject to regulation. For example, an "investment adviser" under the securities laws is a person who provides securities advisory services for compensation;²⁰⁷ a "commodity trading advisor" under the CEA is one who performs a similar

202. See *id.* ("These [end users] suffered from—rather than perpetrated—the 2008 financial crisis.").

203. See *supra* notes 118–25 and accompanying text (listing several of the categories of persons and institutions that Dodd–Frank addresses).

204. See Dodd–Frank Act, Pub. L. No. 111–203, § 723(a), 124 Stat. 1376, 1679 (2010) (codified as amended at 7 U.S.C. § 2(h)(7)(A)(C) (2012)).

205. Commissioner O'Malia has noted the difficulty with the agencies' approach. See Swap Dealer Release, 77 Fed. Reg. at 30,763 (dissenting statement of Comm'r Scott D. O'Malia) (observing that, "if the [CFTC] defines 'swap dealer' expansively, then the [CFTC] will limit the number and types of end-users that may use the clearing exception").

206. See *id.* at 30,611; see also *supra* note 190 and accompanying text (discussing the agencies' position regarding swaps used for hedging purposes).

207. See Investment Advisers Act of 1940, 15 U.S.C. § 80b-2(a)(11) (2013) ("'Investment adviser' means any person who, for compensation, engages in the business of advising others . . . as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.").

role as to commodity futures.²⁰⁸ Determining whether a firm falls within either of these definitions does not require reviewing extensive interpretive guidance and is generally not a facts-and-circumstances analysis. Firms that do not provide advice as to securities or commodities or that do so but do not receive compensation in return are, quite simply, outside the bounds of regulation.²⁰⁹

A clear demarcation between who falls into a regulatory category and who does not both makes good sense and avoids the possibility that those whom Congress did not intend to regulate nonetheless will become subject to regulation. As Part IV elaborates, we should not want to regulate as swap dealers—or as investment advisers or commodity trading advisers—those who are in the role of end user, customer, client, or investor (whatever the preferred label may be). In the swap context, those are the persons who enter into specific swaps to hedge a particular risk based on their assessment of the risk or reward deriving from a reference asset or liability—and who, most often, pursue their swap activities only by obtaining the services of another party, namely, a swap dealer.²¹⁰

B. THE CROSS-BORDER RULES

Title VII provides that its requirements are not to apply to activities outside the United States, unless those activities' connection with U.S. commerce or effect on U.S. commerce is "direct and significant."²¹¹ In issuing rules regarding swap regulation's extraterritorial reach, the CFTC sought to clarify what activities have such a connection with or effect on U.S.

208. See Commodity Exchange Act of 1936, 7 U.S.C. § 1a(12)(A)(i)(I) (2013) ("[C]ommodity trading advisor' means any person who . . . for compensation or profit, engages in the business of advising others . . . as to the value of or the advisability of trading in . . . any contract of sale of a commodity for future delivery, security futures product, or swap.").

209. To be sure, the absence of clear tests and workable safe harbors in the swap context may further the worthy goal of preventing firms from gaming the rules and exploiting loopholes. However, nowhere have the agencies suggested a concern with that objective, and, in any event, they failed to conduct the necessary cost-benefit analysis regarding their regulatory approach in relationship to that objective. See *infra* notes 221-23 and accompanying text (noting the necessity of cost-benefit analysis in the CFTC's rulemaking process).

210. See, e.g., Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 Fed. Reg. 80,174, 80,177-78 (proposed Dec. 21, 2010) ("[N]on-dealers tend to enter into swaps with swap dealers more often than with other non-dealers."). But see Swap Dealer Release, 77 Fed. Reg. at 30,602 (noting commenters' contention that, "in the market for energy swaps[,] . . . swaps entered into directly by two end users are more frequent").

211. Dodd-Frank Act, Pub. L. No. 111-203, § 722(d), 124 Stat. 1376, 1673 (2010) (codified as amended at 7 U.S.C. § 2(i)). Dodd-Frank additionally provides that Title VII's reach may extend also to non-U.S. activities that contravene rules adopted by the CFTC to prevent the evasion of any provision that Dodd-Frank added to the CEA, even if those activities do not have a direct and significant relationship to U.S. commerce. *Id.* However, the CFTC did not base any of its cross-border rules on the "evasion" test, relying, instead, only on the "direct and significant" test.

commerce.²¹² Like the rules pertaining to the definition of swap dealer, however, those rules embody a too-expansive regulatory approach, capturing activities whose relationship to U.S. commerce is neither direct nor significant.²¹³ Specifically, in its cross-border rulemaking, the agency broadened the classes of persons within the scope of swap regulation and overlooked inconsistencies between its regulatory approach and those of the European Union and other jurisdictions, as well as the associated prospect that some persons may be required to comply with two separate regulatory regimes.²¹⁴ After describing the CFTC's unusual approach to promulgating the cross-border rules, this Subpart discusses some of the ways in which the cross-border rules are unduly broad and extend swap regulation beyond the realm Congress sought to regulate. It turns first to the CFTC's definition of "U.S. person" and then to the agency's approach to determining the rules to which each category of swap participant will be subject.

1. Regulatory Approach

The cross-border rules are, in fact, not rules at all. As with any rulemaking that a regulatory agency may undertake, the CFTC's rulemaking process has generally involved, for each rule, a multistep procedure involving proposing the draft rule to the public and receiving and reviewing comments on the proposal before adopting a final version.²¹⁵ The Administrative Procedure Act of 1946 ("APA"),²¹⁶ a statute that was designed to ensure accountability in the rulemaking process and that governs all agency rulemaking, requires those procedures.²¹⁷ Not all of the CFTC's work assumed the form of rules, however, as the previous Subpart's discussion of the swap dealer rules demonstrates. That is, the rulemaking process also required the agency to consider whether interim "rules" should be implemented as transitional steps before full compliance with various final rules would be required and whether the particular circumstances of various persons that otherwise might be subject to

212. See Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013) [hereinafter Cross-Border Rules] (setting forth the CFTC's guidance regarding Title VII's extraterritorial application).

213. Other observers, including one of the CFTC's own commissioners, have voiced similar concerns. See *id.* at 45,371–72 (dissenting statement of Comm'r Scott D. O'Malia) (describing the cross-border rules as "overbroad" and without adequate grounding in the "direct and significant" standard).

214. See *infra* notes 233–39 (describing some of the problems arising from the CFTC's approach to the cross-border rules).

215. The SEC and the CFTC complied with these steps, for example, in connection with their adoption of the swap dealer rules. See Swap Dealer Release, 77 Fed. Reg. at 30,596 (noting that, prior to their adoption of the final swap dealer rules, the agencies proposed draft swap dealer rules, received 968 written comments on them, and held 114 meetings with swap participants).

216. 5 U.S.C. §§ 551–559 (2012).

217. See, e.g., Case Comment, *Public Citizen v. United States Trade Representative*, 5 *F.3d* 549 (*D.C. Cir.* 1993), 107 HARV. L. REV. 1819, 1821 n.21 (1994) ("The primary purpose of the Administrative Procedure Act is to provide a series of procedural checks on administrative agencies.").

a rule counseled in favor of exempting those persons from the rule's reach. The CFTC addressed many of these questions through either interpretive guidance or so-called "no-action" letters—meaning that the agency presumed to alter the scope of various final rules informally, rather than through the more formal, and time-consuming, rulemaking process that the APA mandates.²¹⁸

By-and-large, the CFTC employed the tool of interpretive guidance around the edges, as it were, of the rulemaking process, to ease market participants into compliance or to explain or limit certain rules' applicability. The cross-border rules are an exception, in that, rather than formulate any of them as actual rules, the CFTC promulgated all of them as interpretive guidance.²¹⁹ (This Article nevertheless refers to the collective content of the guidance as the "cross-border rules," given that the CFTC appears to regard that content as enforceable rules.²²⁰) Because the cross-border rules were not the product of the normal agency rulemaking process—they are not rules, after all—they were birthed outside the scope of the APA's safeguards and without an evaluation of whether their benefits exceed their costs,²²¹ as the CEA requires.²²² However, despite the fact that the cross-border rules do not have the force of rules, the CFTC has suggested that they are mandatory, seemingly wanting both to have its cake and to eat it.²²³

218. Cf. SULLIVAN & CROMWELL LLP, CFTC RELIEF AND GUIDANCE AS THE "SWAP" DEFINITION TAKES EFFECT 1 (2012), available at http://www.sullcrom.com/siteFiles/Publications/SC_Publication_CFTC_Relief_and_Guidance_as_the_Swap_Definition_Takes_Effect.pdf (describing the "unprecedented 13 interpretive and no-action letters" that the CFTC issued in October 2012, which "provide clarifications and relief in a number of areas"); *CFTC Issues Range of Swap-Related Interpretive Guidance and No-Action Relief*, GOODWIN PROCTER LLP (Dec. 26, 2012), http://www.goodwinprocter.com/Dodd-Frank/Publications/Newsletter%20Articles/Financial%20Services%20Articles/2012_12/26_08.aspx (describing the no-action exemptive relief that the CFTC granted in December 2012).

219. See Peter Madigan, *CFTC Cross-Border Guidance "Has the Feel of a Rule," Lawyers Agree*, RISK MAG. (Jan. 13, 2014), <http://www.risk.net/risk-magazine/feature/2320806/cftc-cross-border-guidance-has-the-feel-of-a-rule-lawyers-agree> (discussing the CFTC's issuance of "guidance on how to apply its Dodd-Frank regulations to cross-border and overseas trades, rather than binding rules").

220. See *infra* note 223 and accompanying text.

221. See Cross-Border Rules, 78 Fed. Reg. 45,292, 45,373 (July 26, 2013) (dissenting statement of Comm'r Scott D. O'Malia) (noting that, by issuing the cross-border rules as interpretive guidance, the CFTC avoided complying with the APA's safeguards and "also avoided analyzing the costs and benefits of its actions pursuant to section [19](a) of the CEA").

222. See 7 U.S.C. § 19(a)(1) (2013) ("Before promulgating a regulation under this chapter or issuing an order . . . the [CFTC] shall consider the costs and benefits of the action.").

223. See Cross-Border Rules, 78 Fed. Reg. at 45,372 (dissenting statement of Comm'r Scott D. O'Malia) (noting that the cross-border rules "set[] out standards that [they] contemplate[] will be regularly applied by [CFTC] staff to cross-border activities" and that the CFTC has issued "no-action letters . . . in connection with compliance obligations that have essentially been imposed" by the rules); *id.* at 45,371 (statement of Chairman Gary Gensler) (The Cross-Border Rules "provide [] that swap dealers, foreign or U.S., transacting with U.S. persons . . . must comply with Dodd-Frank's swap market reform."); Complaint, *supra* note 9, at 33 (observing that various orders issued by the CFTC providing exemptive relief from compliance with certain cross-border

The CFTC's evasion of the APA's and the CEA's rulemaking requirements is especially problematic because the agency issued the cross-border rules after it had adopted final versions of most of its other swap rules, for which it had adhered to applicable rulemaking strictures.²²⁴ Although the agency provided cost-benefit analyses for those rules, it did not factor in costs associated with the rules' cross-border application—even though the rules' extraterritorial reach could dramatically affect costs and even though, with each rule the agency proposed, market participants urged it to consider extraterritorial application contemporaneously with the rule rather than at some point in the future.²²⁵ Indeed, that the CFTC had not addressed the other rules' extraterritorial application when it proposed them is its ostensible reason for its decision not to promulgate the cross-border rules as actual "rules." It believed that, had it done so, it would have had to re-propose each of the previously adopted rules.²²⁶

2. U.S. Person Definition

The CFTC's impermissibly informal approach to rulemaking arguably produced cross-border rules that are more encompassing than they otherwise would be.²²⁷ In that regard, the agency's definition of "U.S. person"—the

rules "would have been unnecessary, if not for the purposeful binding effect of the Cross-Border Rule[s]").

224. See Complaint, *supra* note 9, at 11 (explaining that the CFTC issued its cross-border rules only after it adopted final swap rules pertaining to "registration, documentation, business conduct, reporting, trade execution, recordkeeping, and mandatory clearing").

225. See *id.* (contending that, in proposing and adopting the other swap rules, the CFTC ignored the concerns "commenters repeatedly expressed" regarding "the rules' extraterritorial application" and that, therefore, "[t]he cost-benefit evaluation required by the CEA [as to those other rules is] fundamentally flawed").

226. See Madigan, *supra* note 219 (noting that, because "many other Dodd-Frank Act [swap] rules were already in place by the time the [cross-border rules] [were] first proposed in July 2012," the CFTC feared that issuing formal cross-border rules would require the agency to "repropose each of those earlier rules").

227. The difficulties arising from the cross-border rules are highlighted by the controversy surrounding the CFTC's November 14, 2013, clarification of some of them. See generally Gary Barnett, Director, Div. of Swap Dealer & Intermediary Oversight, U.S. Commodity Futures Trading Commission, No. 13-69, Applicability of Transaction-Level Requirements to Activity in the United States (2013). In that release, the CFTC further extended the scope of the swap rules to encompass transactions "between a non-U.S. swap dealer and a non-U.S. counterparty booked outside the U.S. . . . if the trade involves 'personnel or agents' located in the U.S." Madigan, *supra* note 219. Several major swap-industry associations perceived the unilaterally expanded guidance as extending U.S. swap regulation far beyond activities with "direct and significant" connections to U.S. commerce and, according to one of their attorneys, viewed it as "the straw that broke the camel's back." See *id.* On December 4, 2013, those associations—the Securities Industry and Financial Markets Association, the International Swaps and Derivatives Association, and the Institute of International Bankers—sued the CFTC, requesting that the court vacate the cross-border rules and "enjoin the CFTC from implementing, enforcing, or giving any extraterritorial effect to its swaps regulation until it promulgates a rule that specifies their extraterritorial

category designating who is squarely within the CFTC's regulatory jurisdiction—is an appropriate place to begin. If, under the CFTC's "U.S. person" definition, a person so qualifies, then that person is subject to the full effect of Dodd–Frank's provisions on swaps and the CFTC's swap rules.²²⁸ So, for example, the person must register as a swap dealer or major swap participant if the person meets the definition for either category and must comply with other relevant requirements, such as clearing and transaction reporting requirements, to the extent required in light of the person's swap-related activities.²²⁹ The "U.S. person definition" is important also because of its effect on non-U.S. persons. Under the cross-border rules, non-U.S. persons dealing with U.S. persons or their non-U.S. affiliates may also become subject to particular components of the swap rules.²³⁰

The definition, like most definitions of U.S. person or similar terms elsewhere in the CFTC's rules, as well as those under the securities laws, provides that natural persons that live in the United States, most entities that are organized or have a principal place of business in the United States, and trusts governed by the laws of any U.S. state are U.S. persons.²³¹ More controversial is the prong of the definition under which a collective investment vehicle, such as a commodity pool or a hedge fund, is a U.S. person if it is majority-owned by the types of U.S. persons described above, even though the fund may be organized under the laws of another country and may be managed by a non-U.S. asset manager.²³²

By capturing entities based on their ownership, the U.S. person definition has the predictable effect of subjecting funds that are already subject to swap regulation in another jurisdiction to the full range of Title VII's provisions and the CFTC's swap rules as well, to the extent applicable based on the fund's activities.²³³ Moreover, in those circumstances, there is no

application consistent with the requirements of the APA and the CEA." Complaint, *supra* note 9, at 2, 6.

228. See Cross-Border Rules, 78 Fed. Reg. 45,292, 45,347 (July 26, 2013) (noting that U.S. persons that are swap dealers or major swap participants "generally would be expected to comply in full with all Entity-Level Requirements and Transaction-Level Requirements, without substituted compliance available").

229. See *id.*

230. See, e.g., *id.* at 45,361 (setting forth the requirements applicable to transactions in which neither party is a swap dealer or a major swap participant, and at least one party is a U.S. person); *id.* at 45,364 (setting forth the requirements applicable to transactions in which neither party is a swap dealer or a major swap participant, both parties are non-U.S. persons, and at least one party is a "guaranteed or conduit affiliate" of a U.S. person).

231. See *id.* at 45,316–17 (setting forth the CFTC's interpretation of "U.S. person" for purposes of CEA section 2(i)).

232. See *id.* at 45,317 (including as a "U.S. person" a collective investment vehicle that is majority-owned by U.S. persons).

233. See Kris Devasabai, *U.S. Person Problems: Hedge Funds Caught in Transatlantic Tug-of-War*, RISK MAG. (Jan. 30, 2014), <http://www.risk.net/risk-magazine/feature/2324313/us-person-problems>

possibility that a fund may satisfy U.S. regulatory requirements by complying with equivalent regulations of the fund's "home" jurisdiction, as might be possible if the fund were a non-U.S. person subject to certain of the CFTC's rules by virtue of its activities.²³⁴ Under the cross-border rules' concept of "substituted compliance," the CFTC may regard a person's "compliance with a comparable and comprehensive regulatory requirement of a" non-U.S. jurisdiction to be an acceptable substitute for the person's compliance with the (otherwise) applicable requirement under U.S. law.²³⁵ Substituted compliance, however, is not available for persons deemed to be U.S. persons and, on that basis, squarely within the CFTC's regulatory scope.²³⁶ Accordingly, those funds falling within the scope of regulation in two jurisdictions may be subject to two complete regulatory regimes, each with its own set of rules and requirements, which may not be compatible with one another.²³⁷ For example, hedge funds based in another jurisdiction, such as the Cayman Islands, that are managed by European investment advisers may be subject to European regulation.²³⁸ However, if the funds have a sufficient magnitude of U.S. investors, they would be deemed U.S. persons and, therefore, also subject to U.S. regulation.²³⁹

Perhaps more problematic still—and presumably stemming from the fact that the U.S. person definition is framed as interpretive guidance—is that the U.S. person definition, as a whole, is, by its express terms, malleable,

hedge-funds-caught-in-transatlantic-tug-of-war (describing the plight of certain European fund managers operating funds that are majority-owned by U.S. persons).

234. See *id.* ("If a fund qualifies as a US person, then it is expected to follow rules laid down by the [CFTC]—substituted compliance is not available.").

235. Cross-Border Rules, 78 Fed. Reg. at 45,295. Substituted compliance may be available if the CFTC "determine[s] that certain laws and regulations of a foreign jurisdiction are comparable to and as comprehensive as a corresponding category of U.S. laws and regulations." *Id.* at 45,340. In the event the CFTC so determines, a firm or transaction in that jurisdiction that is subject to the U.S. regulation as to which comparability applies "will be deemed to be in compliance therewith if that [firm] or transaction complies with the corresponding foreign laws and regulations." *Id.* For a more detailed discussion of substituted compliance, see Sean J. Griffith, *Substituted Compliance and Systemic Risk: How to Make a Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291, 1334–35 (2014).

236. See Cross-Border Rules, 78 Fed. Reg. at 45,347 (noting that substituted compliance is not available for U.S. persons).

237. See Devasabai, *supra* note 233 (noting that the U.S. and European swap regulatory regimes are incompatible in some respects). For example, under European rules, "a firm clearing its OTC trades must be offered a choice of . . . omnibus [or] individual [asset] segregation." *Id.* The CFTC's rules, by contrast, permit just one approach ("legal segregation with operational commingling"). *Id.* Although European regulations may accept a person's compliance with another applicable jurisdiction's regulation as a substitute for compliance with EU regulations—a prospect known as "equivalence"—that is a possibility only as to jurisdictions that the EU has approved. See *id.*

238. See *id.* (describing the circumstances under which "a Cayman-domiciled fund with an EU-based manager" would be subject to European swap regulation).

239. See *id.* (noting that a Cayman Islands-domiciled fund would be subject to U.S. swap regulation if it is majority-owned by U.S. persons).

depending on particular circumstances. The definition is prefaced by the assertion that “the [CFTC] will interpret the term ‘U.S. person’ generally to include, but not be limited to.”²⁴⁰ With that preface, the agency has given itself (very un-rule-like) leeway to determine that a person not falling within the definition should nonetheless be treated as a U.S. person for purposes of Title VII and the swap rules—a discretion that weakens market participants’ ability to be certain that they are in compliance with all regulation that applies to them. Similarly, in the cross-border rules’ discussion of the principal place of business of a collective investment vehicle, the CFTC notes that the agency “does not intend to establish bright line tests for when the principal place of business of a collective investment vehicle would or would not be within the United States.”²⁴¹ To be sure, most such “vehicles”—again, funds—likely will not be in the gray area, but the prospect of there being a gray area in the first place regarding whether the CFTC’s complex web of rules applies is another indicator that the agency’s cross-border approach is not as principled as it ought to be.

It may seem that the CFTC’s U.S. person definition is troublesome primarily because it appears to extend U.S. regulation beyond the realm that Congress intended. To be sure, that concern is, by itself, important. For present purposes, however, the most significant difficulty with the definition is that it serves to extend the CFTC’s problematic approach to the swap dealer definition to swap participants worldwide.

3. Extraterritorial Application

The definition of U.S. person is only the beginning. What follows in the cross-border rules, among other things, is an elaborate discussion of the circumstances under which a non-U.S. person may be required to register as a swap dealer or a major swap participant, a determination that turns on factors such as whether the person is guaranteed by, or is a “conduit affiliate”²⁴² of, a U.S. person and whether the notional value of the person’s swap transactions with counterparties (aggregated with those of its non-U.S. affiliates²⁴³) who are U.S. persons and guaranteed affiliates of U.S. persons

240. Cross-Border Rules, 78 Fed. Reg. at 45,316.

241. *Id.* at 45,311.

242. The CFTC uses the terms “guaranteed affiliate” and “conduit affiliate” to mean, respectively, “a non-U.S. person that is an affiliate of a U.S. person” whose liabilities are “guaranteed by [the] U.S. person,” and “[a] non-U.S. person that is majority-owned . . . by a U.S. person” and that “regularly enters into swaps with one or more of its U.S. affiliates of its U.S. person owner,” provided that the non-U.S. person’s financial statements are included in its owner’s consolidated financial statements. *Id.* at 45,318–19, 45,357.

243. *See id.* at 45,320–23 (setting forth the CFTC’s aggregation principles); Complaint, *supra* note 9, at 42 (“The [cross-border rules] . . . require[] non-U.S. entities . . . to aggregate their swaps with the swaps of every other affiliate ‘under common control,’ including other non-U.S. entities.”).

exceeds the *de minimis* threshold.²⁴⁴ As part of this discussion, the cross-border rules articulate a taxonomy of the other swap rules—covering both the rules that are applicable only to swap dealers and major swap participants and those that may apply to other swap participants, such as clearing and reporting obligations.²⁴⁵ The rules first divide the other swap rules into an “entity level” category and a “transaction level” category, based on whether a particular rule is deemed to apply to a firm as a whole or only to discrete swap transactions.²⁴⁶ They then further divide these groupings into sub-categories based on the purpose of a rule.²⁴⁷

With that groundwork in place, the cross-border rules set forth the CFTC’s policies regarding:

- The circumstances under which U.S.-person and non-U.S.-person swap dealers and major swap participants are subject to the rules within each subcategory,
- The circumstances under which particular rules—in particular, those rules, discussed in Part II, whose applicability does not depend on swap dealer or major swap participant status—apply in connection with cross-border swaps as to which neither party is a swap dealer or a major swap participant, and
- The circumstances under which compliance with a particular rule may be satisfied through substituted compliance.²⁴⁸

To provide a brutishly simplified summary of those policies: U.S. swap dealers and major swap participants are subject to all of the entity-level requirements and all of the transactional-level requirements.²⁴⁹ For their part, non-U.S. swap dealers and major swap participants are subject to the entity-level requirements but, in some cases, may be able to rely on substituted compliance, while the applicability of the transactional-level rules to any

^{244.} See Cross-Border Rules, 78 Fed. Reg. at 45,318–20 (opining that, in determining whether it is a swap dealer or a major swap participant based on having met the *de minimis* threshold, a non-U.S. person that is not a guaranteed or conduit affiliate of a U.S. person need count only those swaps that it enters into with U.S. persons and guaranteed affiliates of U.S. persons (with three exceptions)).

^{245.} See *id.* at 45,331–40.

^{246.} See *id.* at 45,331–33 (describing entity-level requirements); *id.* at 45,333–35 (describing transaction-level requirements).

^{247.} See *id.* at 45,331–35 (discussing the sub-categories within each category). According to the CFTC, the rules in the first subcategory of the entity-level category are aimed at mitigating firm risks, while those in the second category are intended to assist the CFTC in its market oversight. See *id.* at 45,331–33. As for the transaction-level category, the first subcategory encompasses rules designed to mitigate risk and promote transparency, while the second category encompasses “external business conduct standards,” which may not need “to apply to swaps between non-U.S. persons taking place outside the United States.” *Id.* at 45,335–36.

^{248.} See *id.* at 45,348–64.

^{249.} See *id.* at 45,348, 45,350–51, 45,359–60 (setting forth the entity-level and transaction-level requirements applicable to U.S. swap dealers and U.S. major swap participants).

particular transaction depends on the identity of the counterparty—for example, whether the counterparty is a U.S. person or a foreign branch of a U.S. person or, if not, whether it is an affiliate or conduit of a U.S. person.²⁵⁰ As for swaps between two persons (whether U.S. or non-U.S.) that are neither swap dealers nor major swap participants, the applicability of the swap rules to any particular transaction depends on whether either party is a U.S. person or whether, instead, both parties are non-U.S. persons²⁵¹ and, if the latter, whether either party is a guaranteed affiliate or a conduit affiliate²⁵² of a U.S. person and, if so, whether the “inter-affiliate” exemption might apply.²⁵³

As this short description suggests, the cross-border rules are exquisitely complex. Of course, complexity is not, in-and-of-itself, a problem from the standpoint of furthering Dodd–Frank’s goals and regulatory coherence, although that is a question for additional analysis. In the context of the cross-border rules, complexity is a problem because it is a product of the too-broad range of extraterritorial persons and activities over which the CFTC deems its swap rules to apply. By extending the rules so far, the agency inevitably confronted not only questions about how and whether to lessen the prospect of duplicative regulation, but also the need to address, for each possible type of would-be regulatory subject and each rule, myriad permutations based on the possible counterparties those subjects might have. And that is what it did. More specifically, it compiled a set of policies that, as to any particular swap transaction, are likely to apply if the transaction is to any degree connected to the United States or a U.S. person, even if the transaction has more substantial connections to a non-U.S. jurisdiction—one that may have a substantially different approach to swap regulation.²⁵⁴

250. *See id.* at 45,348–50, 45,351–53, 45,360–61 (setting forth the entity-level and transaction-level requirements applicable to non-U.S. swap dealers and non-U.S. major swap participants).

251. In the former circumstance, all of the non-registrant rules apply, without the possibility of substituted compliance. *See id.* at 45,361–63. In the latter circumstance, if neither party is a guaranteed or conduit affiliate only the recordkeeping requirement applies and, even then, only if one of the parties qualifies as a “large trader.” *See id.* at 45,363–64. However, if either party is guaranteed by a U.S. person or a conduit of a U.S. person, then additional non-registrant rules will apply. *See id.* at 45,364.

252. For the definitions of “guaranteed affiliate” and “conduit affiliate,” *see supra* note 242.

253. *See* Cross-Border Rules, 78 Fed. Reg. at 45,362, 45,364.

254. Beyond concerns about the breadth of the cross-border rules are concerns that they are not internally consistent. For example, CFTC Commissioner Scott O’Malia noted in his dissent to the agency’s approval of the cross-border rules that the CFTC is “inconsistent[] and arbitrar[y]” in its determination that certain swap rules “satisfy the ‘direct and significant’ standard under section 2(i).” *Id.* at 45,372. As an example, Commissioner O’Malia cited the requirement that swap transactions be publicly reported, which does not address systemic contagion, and clearing requirements, which do. *See id.* Although the CFTC deems both to be transaction-level requirements (and, hence, applicable extraterritorially), it fails to explain why. *See id.* Commissioner O’Malia also noted his concern “that the [cross-border rules] [are] overlapping, duplicative, and perhaps even contradictory with other provisions in the Dodd–Frank Act that mitigate systemic risk.” *Id.* at 45,374.

Accordingly, the CFTC's approach produces the same concerns as those that have arisen regarding the swap dealer rules.²⁵⁵ More precisely, it reinforces the agency's expansive definition of U.S. person and, together with that definition, expands the already-untenably broad scope of swap dealer regulation to corners of the globe that one might have supposed were beyond U.S. regulatory reach. As Part IV contends, moreover, the approach neither serves the interests of workable and efficient regulation nor comports with Title VII's regulatory temperament.

IV. RETHINKING SWAP REGULATION'S FOUNDATIONS

Now that the dust has mostly settled, it is possible to evaluate Dodd-Frank's swap regulation, as supplemented by the rules adopted by the CFTC. As anticipated, the CFTC's efforts have fundamentally sculpted Title VII's regulatory framework. Perhaps less expected is that those efforts have also produced a financial regulatory regime that departs—inappropriately—from regulators' previous episodes of financial market regulation. This Part both critiques the CFTC's approach to rulemaking under Dodd-Frank and provides an alternative model: Subpart A first assesses the swap rules, contending that their deficiencies derive from the CFTC's narrow focus on the pretending inherent in swaps. Taking the next step, Subpart B asserts that the swap rules would be both more coherent and more effective if they were predicated on the speculation that necessarily is a component of financial market transactions—whether involving swaps or securities.

A. *PRETENDING V. INVESTING*

The CFTC's approach to adopting rules under Title VII of Dodd-Frank is misguided. More specifically, the rules—many of them, at least—are inconsistent with some of the core objectives of swap regulation and hinder the realization of well-functioning, productive, and systemically stable swap markets. We might even say, then, that, as a result of the CFTC's rulemaking approach, swap regulation in the aftermath of that rulemaking looks substantially different than it did beforehand based on the blueprint supplied by Dodd-Frank.

And what was the CFTC's approach? As Part II asserts, the swap rules reflect a particular conception of swaps, in which swaps are instruments predicated on pretense.²⁵⁶ That is, each swap is a contract that involves pretending by both parties to it—each, in a sense, making or receiving payments based on the value of a particular asset that neither party may own and that, in any event, has no formal relationship to the swap itself.²⁵⁷

255. See *supra* notes 195–200 and accompanying text (describing the swap dealer rules' likely impact on end users).

256. See *supra* Part II.A.1 (describing how swap transactions involve pretending).

257. See *supra* Part II.A.1.

Although one party might separately have exposure to the reference asset, the swap *itself* does not involve the purchase or sale of the reference asset.²⁵⁸ As this Subpart contends, this approach to regulation is problematic because the rules it has produced are grounded on a conception of what swaps are, rather than on an understanding of the risks they create.

The CFTC's implicitly pretense-based conception of regulation is not devoid of logic. That logic is evident when one considers that pretending markedly distinguishes transacting in swaps from what is perhaps the cardinal financial market transaction—namely, investing in securities. Fundamental to “investing” in securities is the process whereby an investor, for example, contributes funds or other assets to a firm in return for an ownership interest that the investor hopes will increase in value over time. Or, rather than purchase her ownership interest directly from the firm, the investor might purchase it from other investors who are seeking to dispose of their ownership interests. Either way, through an investor's act of obtaining an ownership interest in a firm, an investor purchases something that has value in its own right: a share of stock or other equity interest (a security), which derives its value from the firm's success—or, more accurately, its managers' success—in deploying the firm's equity capital, rather than from another asset wholly unrelated to itself and with which it has no connection.

We might say, therefore, that investing is one-sided, or unilateral, in that the parties to a securities transaction do not mutually engage in the same activity. That is, they do not both engage in the act of *investing*. By contrast, in pretending, the parties to a swap pretend equally. Recall that not only a swap's value but also the obligations of each party under the swap are based on the reference asset, and neither party need bear any risk relating to the reference asset apart from that created by the swap itself.²⁵⁹ In the contractual relationship that is the swap, the parties jointly pretend that one (or both) of them has purchased, sold, borrowed, or loaned the reference asset.²⁶⁰ We might say, then, that a swap transaction is two-sided, or bilateral.

The CFTC's approach to the swap rules might be viewed as an anti-securities regulatory approach in that, if participation in a swap transaction involves pretending, investing in a security involves anything but. If, moreover, the world of securities investing is unilateral rather than bilateral, then surely it is reasonable for swap regulation to look substantively different from securities regulation. And, thanks to the CFTC's rulemaking, it does. Whereas securities regulation imposes obligations primarily on firms that issue securities and persons that act as intermediaries in securities

258. See *supra* Part II.A.1 (describing the structure of swaps).

259. See *supra* Part II.A.1 (describing the role of the reference asset).

260. See *supra* Part II.A.1.

transactions, rather than on purchasers of securities, the swap rules extend Title VII to encompass virtually everyone.²⁶¹

This conclusion is evident in the CFTC's rules elaborating who is a swap dealer and defining swap regulation's extraterritorial application. In their swap dealer rulemaking, the CFTC and the SEC effectively created a facts-and-circumstances test, eschewing clear and articulable boundaries for who qualifies as a swap dealer and who does not. As a result, the rules effectively echo the bilateral pretense that all swaps involve. The fact of (mutual) pretending entails that if one party is regulated as a "dealer," the other party should be as well, at least if that "other" party transacts in swaps fairly regularly. The cross-border rules, for their part, countenance no clear boundaries to the CFTC's authority to regulate swaps.²⁶² Accordingly, a large swath of swap participants worldwide—regardless of whether they are U.S. persons—may be subject to at least some components of the U.S. swap regulatory regime, depending on who their counterparties happen to be.²⁶³

Yet the suggestion above—that swap regulation is, and should be, bilateral because swap contracts are based on mutual pretense and that securities regulation is, and should be, unilateral because securities transactions are defined by the *un*-mutual activity of investing—is inadequate. It is inadequate because it reflects only the nature of swaps versus securities. It does not reflect the relative status of the parties to a transaction or the relative risks that the transaction creates. Far from revealing additional distinctions between the swap and securities contexts, an evaluation of these factors highlights characteristics that the two contexts share—characteristics that are more salient, for purposes of formulating regulation, than the nature of the two instruments.

Let us return to the notion that a securities transaction involves the sale of a security. Axiomatically, in that transaction, one party is the seller (whether it be the issuer, another investor, or an intermediary), and the other is the buyer. That refocusing of the transaction from what happens in the transaction to the different roles of the parties to the transaction builds a bridge to the swap context. In particular, despite the mutual activities that define the relationship between swap counterparties, those parties similarly have different roles—one party is typically a financial market professional, and the other is typically an end user or other "buy side" firm.²⁶⁴ The

261. See *supra* Part III (describing the ways in which the swap dealer rules and cross-border rules cover, or potentially cover, both parties to a swap).

262. See *supra* Part III.B.3 (discussing the breadth of the cross-border rules).

263. See Complaint, *supra* note 9, at 38 (asserting that "[t]he Cross Border Rule[s] focus[] largely on the status of market participants—such as whether one entity is a subsidiary of, or 'guaranteed' by, another—not their actual 'activities,' as [CEA] Section 2(i) requires").

264. See Willa E. Gibson, *Are Swap Agreements Securities or Futures? The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 J. CORP. L. 379, 382 (1999)

distinction between investing and pretending says nothing about whether, by virtue of being in one role or the other for any transaction, a party is at a relative disadvantage or advantage to the other party.

The distinction, therefore, is problematic as a basis of regulation because, in fact, as in the securities context, the parties to a swap, situated in different roles as they are, are not situated equally. Only one party has an advantage in each of the most pertinent aspects of the parties' relationship: control, expertise, and information. And only one party is in a substantially better position than the other to conduct its activities (or not) so as to serve the cause of tempering systemic instability and ensuring the integrity of financial market transactions.

That is the historic insight of securities regulation. As outlined above, securities regulation may be characterized as a unilateral mode of regulation, but that is not due to the mere fact that, in a securities transaction, only one party invests. Rather, securities regulation is unilateral because it focuses on those with the relative knowledge and, therefore, the relative power. It seeks to ensure that those with whom those persons transact either have power in their own right—they are sophisticated or have bargaining power—or are given access to all relevant information.²⁶⁵ It seeks, in other words, to reduce the parties' unequal status, in the name of protecting investors and promoting market integrity.

Accordingly, apart from the concerns surrounding whether the CFTC's approach to the swap dealer rules unjustifiably departs from approaches used in other rulemaking contexts or whether its approach to the cross-border rules actually accords with APA requirements,²⁶⁶ the swap rules counter their own objectives.²⁶⁷ Both Congress and, ostensibly, the CFTC recognize that, although swap transactions need to be appropriately regulated, they are an important component of liquid and robust financial markets, and regulation should enable their continued uses and functions. It is difficult to see how those objectives are achievable if end users may be regulated as swap dealers

("Usually, parties desiring to enter into swap agreements do not find each other, but rather transact their swap agreements with a swap dealer making a market in certain swap transactions.")

265. See, e.g., *Kennedy v. Tallant*, [1976–1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,779, at 90,820 (S.D. Ga. 1976), (noting that "equalization of bargaining positions" is "[a] common thread running through the fabric of the various securities cases"); *Jackson v. Bache & Co.*, 381 F. Supp. 71, 85 (N.D. Cal. 1974) ("Rule 10b-5 has been utilized to inject some degree of bargaining equality into the purchase and sale of securities.").

266. For a discussion of these concerns, see *supra* text accompanying notes 207–09, 215–23.

267. See, e.g., *Cross-Border Rules*, 78 Fed. Reg. 45,292, 45,293 (July 26, 2013) ("[Dodd–Frank] was enacted to reduce systemic risk . . . increase transparency, and promote market integrity."); *Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act*, 77 Fed. Reg. 41,214, 41,226 (proposed July 12, 2012) (to be codified at 17 C.F.R. ch. 1) [hereinafter *Proposed Cross-Border Rules*] (stating that "the [CEA's] trade execution requirement furthers [Dodd–Frank's] goals of financial stability, market efficiency and enhanced transparency"); *Swap Dealer Release*, 77 Fed. Reg. 30,596, 30,596 (May 23, 2012) ("Title VII . . . established a statutory framework to reduce risk, increase transparency, and promote market integrity within the financial system.").

regardless of whether their activities place them in a position of knowledge and power relative to other market participants²⁶⁸ and if end users or others may be subject to the complete regulation of two separate jurisdictions, regardless of the effects of their activities on U.S. commerce²⁶⁹ and who they are or where they may be located.²⁷⁰

In short, the bilateral approach to the swap rules is troublesome in light of the ways in which the swap markets function. Although both parties to a swap pretend, typically only one of them will have as its business the activity of transacting in swaps. Yet, thanks to the swap rules, swap regulation—and its burdens—capture not only that party but also its customers and clients, such as commercial entities that use swaps to mitigate their exposures to certain types of risks.²⁷¹ While the swap “professional” may be in no better position than its end user counterparty to evaluate the profitability prospects of a swap’s reference asset and, therefore, the swap itself, that party’s activities present solvency risks to its counterparty, as the next Subpart explains.²⁷² Moreover, that party is undoubtedly in a better position to confront and address the concerns that led to swap regulation in the first place: swap transactions that, in the aggregate, create systemic instability and contagion.²⁷³ In these respects, the two parties to a swap—end user, on the

268. See *supra* notes 173–206 and accompanying text (describing the CFTC’s interpretation of the “swap dealer” definition).

269. Then-CFTC Commissioner Jill Sommers made the following observation regarding the CFTC’s cross-border rulemaking:

[The CFTC] staff ha[s] been guided by what could only be called the “Intergalactic Commerce Clause” of the United States Constitution, in that every single swap a U.S. person enters into, no matter what the swap or where it was transacted, was stated to have a direct and significant connection with activities in, or effect on, commerce of the United States. This statutory and constitutional analysis of the extraterritorial application of U.S. law was, in my view, nothing short of extra-statutory and extra-constitutional.

Proposed Cross-Border Rules, 77 Fed. Reg. at 41,239 (statement of Comm’r Jill Sommers).

270. However, based on the contentions in a lawsuit brought by the swap industry’s major participants, that appears to be their effect, as non-U.S. firms—already subject to regulation in their home jurisdictions—eschew transactions with U.S. swap counterparties in an effort to become subject to U.S. swap regulation. See *supra* note 227 (explaining the lawsuit’s background); see also Complaint, *supra* note 9, at 44 (contending that, because “The Cross Border Rule[s] appl[y] the Title VII Rules to foreign entities or entities engaging in foreign transactions,” they “impos[e] costly, often duplicative” requirements, which “discourages entities from engaging in transactions with persons in the United States”). CFTC Commissioner O’Malia has expressed similar concerns. See Cross-Border Rules, 77 Fed. Reg. at 45,374 (dissenting statement of Comm’r Scott D. O’Malia) (“I . . . am concerned about whether the [Cross-Border Rules] create[] an uneven playing field for U.S. firms, which would be a plainly unacceptable outcome to me.”).

271. See Complaint, *supra* note 9, at 44.

272. See *infra* notes 296–303 and accompanying text (describing “counterparty risk”).

273. See *supra* notes 73–93 and accompanying text (describing the role of swaps in the financial crisis).

one hand, and financial market professional, on the other—are far from equally positioned.

Indeed, consider, once again, the securities context. A similar approach to that embraced by the CFTC would have issuer (or intermediary) and investor subject to the same regulation, even though, as noted, the very purpose of securities regulation—protecting investors and promoting market integrity—is to reduce the imbalance of power between issuer and investor.²⁷⁴ This insight is not intended to diminish the differences between securities transactions and swap transactions. Investing in securities is a fundamentally different activity from transacting in swaps and engaging in the pretending that it necessitates. The point, rather, is that, from the perspective of formulating workable, effective regulation, the distinction is far less important than the factor that unites investing and pretending—namely, that both securities and swaps are financial market instruments that center on the risks and rewards of speculation.

B. SPECULATION

The preceding discussions give rise to the question: what might be a better regulatory approach? To begin that analysis, we return again to the securities regulatory context. Despite the differences one might perceive between securities investing and transacting in swaps, the rationales for regulating the securities markets, on the one hand, and the swap markets, on the other, are strikingly similar. Like swap regulation, securities regulation is concerned with ensuring market integrity. Of course, an associated goal of securities regulation is protecting investors—those who place their capital at risk in the securities markets—while swap regulation may be said to have more of a system-wide focus: It seeks to ensure systemic stability. But whether the immediate focus is protecting investors or whether it is protecting the financial system, it is not difficult to see that these emphases are symbiotic and promote one another. A systemically stable financial system protects investors, and protecting investors through disclosure and transparency supports the stability of the financial system.

Perhaps it should not be surprising, then, that there are additional similarities between the rationale for securities regulation and the rationale for swap regulation. In its formulation of a securities regulatory regime after the Depression, Congress opted for an approach aimed at conquering particular problems in the securities markets that had become glaringly evident. Although the problems were varied, a thread that connected them was information—or, more accurately, too little information. One troublesome circumstance, for example, was that companies seeking to raise equity capital could—and, therefore, did—promote themselves (and, by extension, their securities) using exaggerated claims about the companies'

274. See *supra* text accompanying note 265.

prospects.²⁷⁵ Investors, looking for the next new and best thing then as now, rushed to the opportunity, only to suffer the losses that were certain to occur.²⁷⁶ Even companies that were more tempered and whose claims did not stir investors into frenzies were not required to provide the types of information that would be most useful to investors, such as a description of the various risks inherent in owning the companies' securities.²⁷⁷ Accordingly, even in those circumstances investors may have been too exuberant regarding the investments, considering the investments' risks and expected returns.

Perhaps the most formidable problem, however, was fraud in its many permutations.²⁷⁸ Brokers told their clients about hot new securities, even those not suitable for the clients, taking in additional commissions with each sale.²⁷⁹ Investment advisers advised their clients to purchase up-and-coming, "underpriced" securities, knowing that, when the clients did so, the advisers' own holdings of the same securities would increase in value.²⁸⁰ Directors and officers bought stock of their publicly-traded employers before the employers publicly announced a major success or milestone—and without disclosing the news to the sellers—thereby realizing the gains on the stock that inevitably would accrue upon the announcement.²⁸¹ Investment fund managers caused the funds they managed to purchase securities from the managers themselves

275. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 48 (1982) (observing that firms had the discretion to "choose among alternative accounting principles," which they sometimes used "to create an exaggerated impression of [their] worth"); Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 59 OHIO ST. L.J. 1697, 1723 (1998) ("Congress recognized that, prior to the federal securities laws, sellers routinely made exaggerated statements concerning their securities").

276. See STEPHEN J. CHOI & A.C. PRITCHARD, *SECURITIES REGULATION: CASES AND ANALYSIS* 1 (3d ed. 2012) (noting that one of Congress's goals in enacting the securities laws "was to discourage speculative frenzies among investors tempted to chase after the next big thing").

277. See Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons from History*, 106 COLUM. L. REV. 1793, 1813-14 (2006) (explaining that, until Congress enacted the Securities Act, managers were "not compel[led] . . . to disclose information to shareholders, and little information was indeed disseminated").

278. See H.R. REP. NO. 73-85, at 2 (1933) (observing that fraud in the securities markets was prevalent in the years leading to the Great Depression).

279. This practice is known as "churning." See *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 820 (9th Cir. 1980) (defining "churning" as a broker's "excessive trading in disregard of his customer's investment objectives for the purpose of generating commission business").

280. See SEC, *INVESTMENT TRUSTS AND INVESTMENT COMPANIES*, H.R. DOC. NO. 76-477, at 29 (1939) (describing troublesome aspects of the early U.S. investment advisory industry, including "trading by investment counselors for their own account in securities in which their clients were interested").

281. See COMM. ON BANKING & CURRENCY, STOCK EXCHANGE S. REP. NO. 73-1455, at 55 (1934) (observing that corporate officers and directors "used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities"); Michael P. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 56-57 & n.239 (1980) (describing Congress's concerns regarding insider trading activity at the time it formulated the securities laws).

at prices the managers would not be able to obtain in the open market and without disclosing that practice to the funds' investors.²⁸²

Congress perceived that the way to address these problems was to ensure that investors had adequate information—*truthful* information—both to enable them to evaluate the risks of any investment and to curb fraudulent activity.²⁸³ Of course, particularly for the latter goal, adequate enforcement was also critical, as was ongoing oversight of broker-dealers, investment advisers, and other market professionals.²⁸⁴ But information was the most essential ingredient, necessary to level the imbalances between those proposing a transaction or standing to benefit from it, on the one hand, and investors, on the other. It was only through ensuring that investors were informed that investors could be protected.

But from what, exactly, did they need protection? Fraud? Get-rich-quick schemes? Their own excessive exuberance? Glossy brochures? Aggressive sales pitches? All of the above. They needed protection from speculation. Speculation in this context is not a problem but a fact. And it has its commonly known meaning: it is the act of engaging in a transaction in the securities markets that promises rewards (in the form of investment returns), but that also carries risks, possibly considerable ones at that.²⁸⁵

Speculation is not bad; indeed, it is inherent in investing. Every investment that does not serve as a hedge is based on speculation. Real estate investors buy real estate based on the speculation that the property will increase in value; investors that buy precious metals, art, or securities have the same considerations in mind. Indeed, we might go so far as to say that every contract involves speculation. Parties enter into contracts to receive the benefit of a promise, typically to be carried out at some point after the contract is executed.²⁸⁶ Each party speculates that the benefit it will receive in

282. See Edwin P. Rome, Note, *Regulation of Investment Companies*, 88 U. PA. L. REV. & AM. L. REG. 584, 588 (1940) (noting “self-dealing” as an abusive practice that the SEC sought to address).

283. See CHOI & PRITCHARD, *supra* note 276, at 1 (observing that, in enacting the securities laws, “Congress’ primary goal was to protect investors who were considering putting capital into the country’s financial markets . . . by encouraging full disclosure and deterring fraud”).

284. See *id.* at 37–39 (summarizing the U.S. securities laws and noting the role of the Exchange Act, the Investment Advisers Act of 1940, and the Investment Company Act of 1940 in regulating market professionals).

285. See, e.g., *Speculation*, OXFORD DICTIONARIES, http://www.oxforddictionaries.com/us/definition/american_english/speculation (last visited Mar. 18, 2015) (defining “speculation” as “[i]nvestment in stocks, property, or other ventures in the hope of gain but with the risk of loss”). This definition—the first result listed in a Google search for “speculation” on March 30, 2015—arguably is somewhat broader than another commonly-cited definition, which confines speculation to short- or mid-term investments characterized by the prospect of very large rewards but also very large possible losses. See *Speculation*, DICTIONARY.COM, <http://dictionary.reference.com/browse/speculation> (last visited Mar. 18, 2015) (defining speculation as “engagement in business transactions involving considerable risk but offering the chance of large gains”).

286. See Aaron D. Goldstein, *The Public Meaning Rule: Reconciling Meaning, Intent, and Contract Interpretation*, 53 SANTA CLARA L. REV. 73, 122 (2013) (asserting that contracts are “promises

the future is worth its cost. Without speculation, there are no securities markets—or, indeed, any financial markets. After all, speculation about something, distilled to its simplest terms, is to have an idea or guess about its outcome but not to have certainty about it.²⁸⁷ If there is any certainty in securities investing, it is that there is no certainty.

A byproduct of speculation, however, is misjudgment—investors' incorrect evaluation of rewards versus risks. That misjudgment is exacerbated by the intangible nature of securities.²⁸⁸ Because investors cannot kick the tires, as it were, of the securities they buy, they may be unduly swayed by dreams of riches, other investors' enthusiasm, performance that is too good to be true, and, of course, false or misleading information.²⁸⁹ Speculation in the securities context, put another way, necessitates that investors rely on information from outside sources.²⁹⁰ Only if they have access to the right kind of information and only if that information is truthful can misjudgment be minimized, creating the greatest possibility that speculation will be successful and that the securities markets will thrive.

That is the aim of securities regulation. The securities laws and their emphasis on disclosure seek to dampen unsubstantiated speculation by requiring that investors be told exactly what they are getting into in placing their assets at risk.²⁹¹ With that information, they can make informed decisions—informed *speculative* decisions, that is. Accordingly, securities regulation compels those who may otherwise not be inclined to provide information to do so, which, in turn, produces the following state of affairs:

backed by coercive force” that people enter into “to ensure that other people will do particular things at or by a particular time”).

287. See *supra* note 285 (using such terms as “risk,” “chance,” and “hope” to characterize speculative activity).

288. See, e.g., Eric D. Roiter, *Illegal Corporate Practices and the Disclosure Requirements of the Federal Securities Laws*, 50 FORDHAM L. REV. 781, 783 (1982) (“In contrast to products that lend themselves to physical inspection, securities are intangible interests.”).

289. See Samantha Booth, *Here Comes the Sun: How Securities Regulations Cast a Shadow on the Growth of Community Solar in the United States*, 61 UCLA L. REV. 760, 779 (2014) (“Because securities are intangible financial rights . . . they are especially susceptible to fraud, for example by unscrupulous salespeople who make grand claims and thereby talk unsophisticated purchasers into buying certificates unsubstantiated by any real economic value.”); Poser, *supra* note 101, at 1096 (“[S]ecurities are intangible merchandise, the sale of which is peculiarly subject to abuse.”).

290. See Roiter, *supra* note 288, at 783 (observing that “participants [have] the opportunity to make informed investment judgments . . . [because of] Congress’s imposition of affirmative disclosure obligations”).

291. Cf. Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 874 (1995) (observing that one of the goals of disclosure in securities regulation is achieving “accurate market valuations”); Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 81 WASH. U.L.Q. 403, 403 (2003) (noting that the goal of securities regulation “is quality disclosure to inform shareholders and would-be shareholders”).

As to any particular securities investment, the regulatory burden is on one party to the transaction, but not the other.²⁹²

The securities markets and the swap markets may be quite different, but they have speculation in common. Much like placing assets in a security, the act of entering into a swap has an unknowable outcome.²⁹³ One—an end user, say—can evaluate the swap's prospects as best she can, focusing on the reference asset and its chances of appreciation or default. The end user needs to evaluate more than that, however. She needs to understand the functioning of the agreement itself, for that agreement is the financial instrument (and not the reference asset).²⁹⁴ In that regard, she needs to know the agreement's terms, focusing perhaps on its default, liability, collateral payment, termination, and dispute resolution provisions, among many others.²⁹⁵

Perhaps most important of all, she needs to analyze the financial soundness of her counterparty—which, in the typical case, is a financial services firm whose business is to engage in swap and other financial transactions and whose transactions are often financed through substantial leverage, or debt.²⁹⁶ The importance of this factor should be apparent: Regardless of the reference asset for a swap and how it performs over the life of the swap, any payments to a party under a swap contract based on that performance come from the other party to the swap. That is simply a product of how a swap works.²⁹⁷ Because it is nothing more than a contract, any benefit of the bargain to one party is determined by the terms of the contract itself. So, for example, if an end user has the long leg of a total return swap that references LinkedIn—meaning that the end user hopes for appreciation in LinkedIn's value—if LinkedIn actually does appreciate, the end user must look to her counterparty to pay the amount of that appreciation.²⁹⁸ If the counterparty is insolvent, she has no recourse (beyond her legal remedies as

292. See Iris H-Y Chiu, *Delegated Regulatory Administration in Mandatory Disclosure—Some Observations from EU Securities Regulation*, 40 INT'L LAW. 737, 762 (2006) (describing how “[m]andatory disclosure attempts to redress information asymmetry between investors, issuers, and the markets” in order to assist investors in attaining “the best possible investment and execution”).

293. See *supra* Part II.A (describing how swaps are structured and function).

294. See John C. Dugan, *Derivatives: Netting, Insolvency, and End Users*, 112 BANKING L.J. 638, 646 n.19 (1995) (noting that swaps are a type of financial instrument).

295. See FIELD FISHER WATERHOUSE, COMMENTARY ON THE ISDA MASTER AGREEMENT 3 (2008), available at <http://www.fieldfisher.com/media/1979379/Commentary-ISDA-master-agreements.pdf> (describing terms of ISDA Master Agreements, which are form agreements that are “used to document a wide range of derivative transactions,” including swaps).

296. See Eric D. Roiter, *Should Money Market Funds Be Designated as “SIFIs”?*, 31 REV. BANKING & FIN. L. 749, 756 (2012) (observing that “broker-dealers and [other] finance companies” are “highly leveraged firms”).

297. See David Harper, *Introduction to Counterparty Risk*, INVESTOPEDIA, <http://www.investopedia.com/articles/optioninvestor/11/understanding-counterparty-risk.asp> (last visited Mar. 18, 2015) (observing that swaps and other derivatives involve payments by one party to the other).

298. See *supra* notes 43–47 and accompanying text (describing total return swaps).

a creditor and under the contract).²⁹⁹ Lest this possibility seem unlikely, at least when the counterparty is a large and established firm, we need only recall AIG.³⁰⁰ Or Lehman Brothers. Or Bear Stearns. In 2008, counterparty default was at the heart of systemic contagion and, therefore, the financial crisis itself.³⁰¹

At the end of the day, the best an end user can hope for in her evaluation of a swap is to develop a reasonable understanding of the swap's rewards and its risks, particularly its counterparty risk.³⁰² She is speculating, after all. Accordingly, as in the securities context, if the need to evaluate is great, so is the need for information. As Subpart A discusses—and also as in the securities context—the parties to a swap are not equally situated in terms of the evaluation process. Whereas, in the securities markets, an issuer, insider, or market intermediary (such as a broker) is typically at an information advantage, so it is, as well, in the swap markets, where the advantage rests with those who make a business out of transacting in swaps.³⁰³

Or, perhaps a better characterization of the relative situation of the parties is that the *dis*advantage rests with end users—and that disadvantage is due primarily to counterparty risk. In particular, the discussion above notes three components of a swap transaction requiring evaluation.³⁰⁴ Regarding the reference asset, the dealer should, in general, have no special insight, particularly because that asset is usually selected based on the end user's hedging needs or profit-generating ideas.³⁰⁵ As for the swap—the contract—itsself, although the dealer typically is the source of the base agreement and, therefore, its terms, the contract negotiation process helps to balance those

299. See Harper, *supra* note 297 (describing counterparty risk in the swap context and concerns arising from it).

300. See *supra* notes 78–91 (describing AIG's role in the financial crisis).

301. See Harper, *supra* note 297 (describing the relationship of counterparty default to systemic risk).

302. See Buffett Letter, *supra* note 87, at 13 (“Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them.”).

303. See Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n, Chairman's Message for the Agency Financial Report (Nov. 15, 2012), available at <http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement111512> (noting that swap dealers have an information advantage in the swap markets); Letter from Timothy W. Cameron, Managing Dir., Asset Mgmt. Grp., Sec. Indus. & Fin. Mkts. Assoc., to David A. Stawick, Sec'y, Commodity Futures Trading Comm'n 10 (Feb. 22, 2011), available at <http://www.sifma.org/comment-letters/2011/sifma-amg-submits-comments-to-the-cftc-on-business-conduct-standards-for-swap-dealers-and-major-swap-participants-particularly-special-entities/> (“Swap dealers already have an information advantage by virtue of entering into both sides of transactions.”).

304. See *supra* notes 293–301 and accompanying text.

305. This is evident from the definition of swap dealer and, specifically, the prong of that definition providing that a swap dealer is one who holds itself out as willing to deal in swaps at the request of other parties. See *supra* notes 160–63 (discussing the swap dealer definition).

terms, to the extent they are unduly dealer-friendly.³⁰⁶ Counterparty risk, however, is more intractable. It is the factor about which swap participants most need information to make their speculative decision about a swap transaction.³⁰⁷ Historically, however, that information—or, in lieu of information, confidence that counterparty risk is not excessive—has been the most difficult to come by and to evaluate.³⁰⁸

And that is Dodd–Frank’s key regulatory insight in the swap context. An important swath of Title VII’s substantive requirements applies only to those firms who fall within the definition of swap dealer. In Title VII’s blueprint, swap dealers must adhere to capital and margin rules—meaning that they must maintain a minimum amount of capital and supply a minimum amount of collateral to the relevant clearinghouse or counterparty in connection with their swap activities.³⁰⁹ They must also maintain various records regarding their swap transactions (and allow regulators access to those records),³¹⁰ adhere to business conduct standards intended to curb fraud and other abusive practices,³¹¹ and ensure adequate oversight of their businesses.³¹² As part of their oversight obligations, they must create and implement “robust and professional” risk management procedures, as well as procedures reasonably designed to mitigate conflicts of interest among certain firm personnel.³¹³ Additionally, they must appoint a chief compliance officer (“CCO”) to oversee the firm’s and its employees’ adherence to those and other policies and procedures.³¹⁴ The CCO must report to a senior officer³¹⁵ and, at least annually, deliver a certified report to the CFTC regarding the firm’s compliance with Dodd–Frank and the associated agency rules.³¹⁶

Swap dealers—used here to refer to relevant financial market professionals rather than everyone who might be encompassed by new regulatory interpretation of the term—are the party to a swap transaction that

306. Swaps are, after all, privately negotiated instruments. See *supra* notes 100–12 and accompanying text (noting that swaps are negotiated agreements).

307. See Rob Roy, *Default Swaps Intensify Credit Crunch*, MINYANVILLE (Feb. 11, 2008, 11:30 AM), <http://www.minyanville.com/businessmarkets/articles/CS-C-db-MBI-WB-bcs/2/11/2008/id/15847> (claiming that counterparty risk—the “risk that the other party in an agreement will default”—is the “greatest risk of all” in the swap markets).

308. See David Rowe, *Banks Have Done Too Little, For Too Long on Counterparty Data*, RISK MAG. (Feb. 21, 2014), <http://www.risk.net/risk-magazine/opinion/2329630/banks-have-done-too-little-for-too-long-on-counterparty-data> (describing the difficulties associated with firms’ collection and analysis of counterparty risk data).

309. See Dodd–Frank Act, Pub. L. No. 111-203, § 731, 124 Stat. 1376, 1704–05 (2010) (codified as amended at 7 U.S.C. § 6s(e) (2012)).

310. See *id.* (codified as amended at 7 U.S.C. § 6s(f), (g)).

311. See *id.* (codified as amended at 7 U.S.C. § 6s(h)).

312. See *id.* (codified as amended at 7 U.S.C. § 6s(j)).

313. See *id.* (codified as amended at 7 U.S.C. § 6s(j)(2), (5)).

314. See *id.* (codified as amended at 7 U.S.C. § 6s(k)).

315. See *id.* (codified as amended at 7 U.S.C. § 6s(k)(2)(A)).

316. See *id.* (codified as amended at 7 U.S.C. § 6s(k)(3)).

should bear the regulatory burdens. By the same token, there is less need for regulation of their non-dealing counterparties, whose solvency can be more readily evaluated in the same manner that banks evaluate businesses to which they lend capital.³¹⁷ Put another way, a regulatory approach founded on speculation recognizes that, in most transactions, only one party speculates. Only one party is at a disadvantage in making an informed decision about a transaction with a presently unknowable outcome. That party is the end user. Meanwhile, the dealer is at a substantial advantage—indeed, it has control—as to the factor that is arguably the most important for an end user: Will the dealer remain solvent, or will its risky trading and dealing activities cause its downfall?

Swap dealers have an additional advantage over end users, one that goes beyond discrete swap transactions. In particular, they enjoy a vantage point, derived from their own dealing activities, from which they may discern more aggregated activity in the swap markets—trends, notional amounts, types of swaps, categories of end users, and so on. That vantage point means that swap dealers may play an important role in furthering Dodd–Frank’s specific mission of mitigating systemic risk and promoting market integrity, as possible suppliers of the data that regulators deem critical in understanding the swap markets and the nature of the risks that they harbor.³¹⁸ Accordingly, it constitutes yet another reason for placing the burdens of regulation on swap dealers, as parties who enable both speculation and regulators’ ability to react to its excesses. It also constitutes yet another reason why the regulatory logic that Title VII embodies has nothing to do with pretense, mutual or otherwise.

V. CONCLUSION

The financial crisis demonstrated all too palpably that regulation of swaps and the swap markets is critical. It did not, however, produce the conclusion that swaps serve no productive purposes in the financial markets—and, indeed, the opposite is the case.³¹⁹ Accordingly, the task of formulating swap regulation was the task of building safeguards for systemic stability in a way that did not unduly hinder those productive uses. By-and-large, that task fell

317. See Charles E. Davidson, *Environmental Considerations in Loan Documentation*, 106 *BANKING L.J.* 308, 308 (1989) (observing that lenders’ “standard operating procedure” has encompassed “a due diligence review based on the industry or business of the borrower, its management, the borrower’s cash flow, and/or the value of collateral, depending on the nature of the transaction”).

318. This vantage point is also reflected in Title VII, which requires swap dealers periodically to report to the CFTC extensive information about their swap dealing activities. See Dodd–Frank Act § 731(f)(1)(A) (codified as amended at 7 U.S.C. § 6s) (requiring a swap dealer to “make such reports as are required by the [CFTC] . . . regarding [its] transactions and positions and financial condition”).

319. See *supra* notes 195–96 and accompanying text (describing the purposes for which end users use swaps).

to the CFTC, and, by-and-large, the agency failed at it, as was most vividly evident in the market's reaction.³²⁰

The good news, however, is that moving toward a better regulatory regime based on sounder regulatory principles—principles consonant with those that underlie securities regulation—is feasible. What is required is a reorientation of the CFTC's approach, one that recognizes that the mutual activity of pretending that inheres in a swap transaction is relevant only as a descriptor of the transaction and not as a normative basis of regulating it. The new approach should draw its normative force, instead, from swap counterparties' differential advantages and differential risk characteristics. That is, it ought to train most regulatory obligations on the party that has the most information and that presents the greatest risks—the party, in other words, that deals in swaps, with “deal” having that meaning that it has traditionally had in the securities context rather than as the CFTC would have us understand the term.³²¹ This means that the CFTC needs to return to the drawing board. Of course, the agency's heeding this Article's call and doing so will result in further delay to the regulation of swaps that has been necessary for so long. However, the goal of ensuring well-functioning financial markets would have it no other way.

320. See *supra* notes 198–200 and accompanying text (describing some swap participants' reactions to the swap rules).

321. See *supra* Part IIIA (describing the CFTC's unduly broad interpretation of “swap dealer”).