2013

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Recommended Citation

Rauterberg, Gabriel and Andrew Verstein. "Assessing Transnational Private Regulation of the OTC Derivatives Market: ISDA, the BBA, and the Future of Financial Reform." *Virginia Journal of International Law* 54, no. 1 (2014): 9-50.

ARTICLE

Assessing Transnational Private Regulation of the OTC Derivatives Market: ISDA, the BBA, and the Future of Financial Reform

GABRIEL V. RAUTERBERG & ANDREW VERSTEIN*

For the last twenty years, the dominant narrative of the over-the-counter derivatives market has been one of absent regulation, deregulation, and regulatory conflict, predictably resulting in disaster. This Article challenges this narrative, arguing that the global derivatives market has been subject to pervasive and harmonized regulation by what should be recognized as transnational private regulators. Recognizing the reality of widespread transnational private regulation of derivatives has significant implications, which this Article explores. Appreciating the actual regulatory status quo is essential if policymakers are to correctly diagnose problems, avoid past regulatory errors, and plan effective remedies. There are also advantages to relying on private transnational regulation, as increased governmental effort to regulate the OTC derivatives space may undermine and fracture existing regulation. To be sure, private transnational regulation carries risks that have sometimes materialized, such as the manipulation of LIBOR. Thus, this Article also evaluates best practices in regulating through transnational private governance.

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INTRODUCTION

There is a consensus that in order to avoid the mistakes that precipitated the global financial crisis, new and internationally coordinated regulatory solutions are needed.[1] Indeed, both proposals and recently enacted legislation have already dramatically altered the regulatory requirements for major commercial and investment banks, as well as targeted the over-the-counter (OTC) derivatives markets, which have been viewed as a key causal factor in the crisis.[2] The narrative for the OTC derivatives market has almost uniformly been described in the following manner: for the last twenty years it was a largely unregulated market, and this lack of regulation was key to the role OTC derivatives played in causally contributing to the financial crisis and subsequent market woes. In brief, OTC derivatives were deregulated and this led to disaster — or so the story goes.

This narrative, however, is incorrect and dangerously so. We dedicate the first part of this Article to demonstrating why. The basic contours of this argument have been noted by other derivatives scholars in recent work. Far from being unregulated, the OTC derivatives market was subject to pervasive regulation and governance, although by transnational private regulators rather than government. Most prominently, these private

1. *See, e.g.*, 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 (2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

2. *See infra* notes 37, 39.

regulators have been the International Swaps and Derivatives Association (ISDA) and the British Bankers' Association (BBA). Indeed, we argue that the U.S. and U.K. governments are best understood as having consciously chosen to regulate the OTC derivatives through reliance on transnational private regulation.

We join with other scholars of the OTC derivatives market in finding it crucial to appreciate the significance of its underlying transnational private regulatory structure. But we go further in asking about the implications of understanding the underlying regulatory structure of the OTC derivatives market. This Article is about assessing these implications — for harmonization, reform, and responsibility — of taking transnational private regulation seriously. We make a series of arguments concerning lessons to be learned from ISDA and the BBA, ways to improve the regulation of derivatives, and the promise of governmental leveraging of transnational private regulation. Above all, we conclude that we cannot hope for better, more successful regulation — and to avert the next financial crisis — until we understand and appreciate the actual regulatory character of the past two decades.

I. TRANSNATIONAL PRIVATE REGULATION OF OTC DERIVATIVES

This Section begins by introducing the OTC derivatives market. It then describes the view of the OTC market as unregulated. Next, it considers the possibility of transnational private (i.e. non-state) regulation of the OTC market. Finally, we examine the ways in which the OTC market can be considered to have been subject to extensive transnational private regulation.

A. Introduction to Derivatives

Financial derivatives are investment instruments that derive their value from some other financial asset.[3] For example, a call option, a type of derivative, gives the owner of the option the privilege, but not the obligation, to purchase a specified asset at a specified price at some future date. That privilege may someday be of great value if the underlying asset appreciates, in which case the right to purchase it at a low price represents a guaranteed profit. On the other hand, if the underlying asset depreciates, the call option is unlikely to be used to any gain. Since the call option is an alienable asset, its sale price will reflect in some way the movement in price of the underlying asset.

3. ALAN N. RECHTSCHAFFEN, CAPITAL MARKETS, DERIVATIVES AND THE LAW 159 (2009) ("A derivatives transaction is 'a bilateral contract . . . whose value derives . . . from the value of an underlying asset or underlying reference rate or index.'").

Financial derivatives serve at least three purposes for their users. First, they can be used to hedge, or offset, risk.[4] Farmers have long used futures, obligations to deliver a given asset at some upcoming date, to lock in their profits now and avoid the volatility of the market for their crop. Swaps, which are promises on the part of two parties to exchange a stream of payments, are now used by the majority of large firms to reduce their interest-rate risk. Companies agree to pay a fixed rate to their bank in exchange for a payment stream that varies with the interest rate, thus assuring themselves an income stream that will vary inversely to their borrowing costs.

Second, derivatives are also used for speculation. Call options can be a more cost-effective way to bet on the appreciation of a security than the direct purchase of the security. Call options entitle their owner to similar gains akin to owning the underlying security, but with a lower initial cost.[5] Similar derivatives allow investors to cheaply bet that a security will decline in value, or simply change in some direction.[6]

Finally, derivatives can be used for a variety of arbitrage activities. Arbitrage refers to investment or business activity that notes the economic similarity between two seemingly different assets. The notorious hedge fund Long-Term Capital Management used financial derivatives to bet that the prices of similar assets would eventually converge.[7] Arbitrage can also be regulatory: where a transaction has substantial regulatory costs, derivatives may sometimes be used to reconstruct the transaction in terms not covered by the regulation, preserving the economics of the transaction but avoiding the regulation.[8] For example, a corporation may incur tax liability if it sells a given security. Instead of selling the security, the corporation may initiate a total return swap in which it promises to pay another party an amount reflecting any change in value in the asset, in exchange for a fee. Now the corporation has achieved the equivalent of a sale but has not actually "sold" anything for regulatory purposes.

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4. *See generally id.* at 159–73.

5. Access to similar returns comes paired with a greater risk of no return at all. If the option expires while the security's price is below the option's strike price, the investor receives no payment at all.

6. A "straddle" is a combination of a call and a put option that rewards its owner if the security's price changes in either direction.

7. *See* ROGER K. LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000).

8. *See* MERTON H. MILLER, MERTON MILLER ON DERIVATIVES 6 (1997) (explaining and praising regulatory arbitrage); Kenneth C. Kettering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1661–67 (2008) (arguing that although bank loans and standby letters of credit expose banks to similar credit risks, the Office of the Comptroller of the Currency (OCC) treated standby letters of credit to the more favorable regulatory treatment of regular letters of credit. In this way, the OCC created a profitable regulatory arbitrage for banks to issue standby letters of credit rather than make loans).

Derivatives come in two well-recognized forms: exchange-traded and over-the-counter. The former are standardized contracts traded on regulated exchanges, such as the Chicago Board Options Exchange. The latter are bilateral, designed for customizability, and comprise the vast proportion of the derivatives market.[9]

Given the OTC market's focus on customization, it is perhaps surprising how closely different OTC swaps resemble one another. This notable fact is largely a result of the standardization of customizable terms provided by ISDA's Master Agreement form contracts and accompanying documentation. Hundreds of trillions of dollars of OTC derivatives are governed by documents written by a single organization, the ISDA, and derive their payments from a single rate governed by another, the BBA. These two organizations are critical in generating the infrastructure that has ordered transactions in the OTC derivatives markets for much of the last two decades — an infrastructure that provides the multiple economic benefits of liquidity, certainty, and reduced transaction costs.[10]

ISDA is "the largest global financial trade association,"[11] with over 800 members from fifty-five countries.[12] ISDA's trade documentation is the market norm for OTC derivatives,[13] and the organization exercises tremendous influence over the form that transactions take.[14] As just one

9. *See, e.g.*, Colleen M. Baker, *Regulating the Invisible: The Case of Over-the-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287, 1300 (2010) (citations omitted) ("OTC derivative markets are many times the size of exchange-traded markets and compromise [sic] roughly eighty-three percent of the derivative market.").

10. RECHTSCHAFFEN, *supra* note 3, at 172–73.

11. David Mengle, *Concentration of OTC Derivatives Among Major Dealers*, ISDA RESEARCH NOTES, no. 4, 2010, at 7, *available at* http://www.isda.org/researchnotes/pdf/ConcentrationRN_4-10.pdf.

12. INT'L SWAPS & DERIVATIVES ASS'N, ISDA: SAFE, EFFICIENT, MARKETS (2011), http://www.isda.org/uploadfiles/_docs/ISDA_Brochure_2011.pdf.

13. *See, e.g.*, BNP PARIBAS, OTC DERIVATIVES: THE CHALLENGE OF DERIVING CLEAR BENEFITS 18, *available at* http://securities.bnpparibas.com/jahia/webdav/site/portal/shared/documents/Market%20Insight/White-paper-OTC-Derivatives.pdf ("the bilateral agreement adopted between two counterparties dealing OTC derivatives is typically the master agreement published by the International Swaps and Derivatives Association (ISDA)."); INT'L SWAPS & DERIVATIVES ASS'N, MARKET REVIEW OF OTC DERIVATIVE BILATERAL COLLATERALIZATION PRACTICES 9 (2010) ("OTC derivative transactions are commonly documented pursuant to either a 1992 Multi-Currency Cross Border ISDA Master Agreement (the 1992 Agreement) or a 2002 ISDA Master Agreement").

14. *See, e.g.*, Adam J. Krippel, *Regulatory Overhaul of the OTC Derivatives Market: The Costs, Risks and Politics*, 6 OHIO ST. ENTREPRENEURIAL BUS. L.J. 269, 280 (2011) ("The International Swaps and Derivatives Association, Inc. ('ISDA') provides a standard form agreement called the 'ISDA Master Agreement' that most market participants use for their OTC derivatives transactions."); Adam Glass, *Helpful Hints for the New Derivatives Regulators*, FINREG21.COM (Aug. 31, 2009), http://www.finreg21.com/lombard-street/helpful-hints-new-derivatives-regulators (explaining that ISDA "is the forum in which the swap dealers and other market participants create and administer the terms and conditions of every major class of OTC derivative. It publishes and updates standard contract terms, takes positions or seeks outside counsel on interpretive questions under those standardized terms, and, in the case of credit derivatives, is single-handedly responsible for rewriting

indicator of the extent of ISDA's penetration, eighty-five percent of the approximately 138,000 collateral agreements in use in the OTC derivative market at the end of 2011 were ISDA agreements.[15] "The [ISDA] Master Agreement serves as an industry-standard contract available for off-the-shelf use by counterparties."[16]

The importance of the BBA over the last two decades is similarly indisputable.[17] The BBA's importance to the derivatives market began in 1986 when it first published a daily interest-rate benchmark called the BBA London InterBank Offered Rate (LIBOR).[18] Assembled from banks' self-evaluated borrowing costs, LIBOR is meant to provide insight into the cost of funds in the most liquid market in the world. Because of the importance of the banks that operate in the London market, LIBOR is thought to correlate with interest rates all around the world. That benchmark rate is now the price term in essentially all USD-, Yen-, and Sterling-denominated OTC derivatives.[19]

Although they are small private entities, ISDA and the BBA produce standards of tremendous public influence and importance:[20] the standard form documentation that is the norm for the OTC derivatives market, and the rate by which hundreds of trillions of dollars in interest-rate derivatives are traded.

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the standard terms of credit derivatives, and changing the market practices under which they are traded and settled"), *reprinted in* http://creditriskchronicles.blogspot.com/2009/08/helpful-hints-for-new-derivatives.html.

15. INT'L SWAPS & DERIVATIVES ASS'N, ISDA MARGIN SURVEY 2012 3 (2012), *available at* https://www2.isda.org/functional-areas/research/surveys/margin-surveys/.

16. RECHTSCHAFFEN, *supra* note 3, at 173.

17. Interestingly, there is some overlap between ISDA and the BBA. ISDA grew out of efforts in the early 1980s to standardize OTC derivatives. Among early efforts, the British Bankers' Association formed an Interest Rate Swap Working Party and Forward Rate Agreement Working Party that developed a set of standardized terms for interest rate swaps and forwards. GuyLaine Charles, *The ISDA Master Agreement — Part I: Architecture, Risks and Compliance*, PRAC. COMPLIANCE & RISK MGMT. FOR SEC. INDUS., Jan. 2012, at 25, 25–26, *available at* http://www.teiglandhunt.com/webcp/assets/rtarticles/pdf/77.pdf. The BBA formed in 1920 through the merger of two other banking organizations but remained insignificant until the 1970s. Until that time, it addressed issues only on an ad hoc basis and shared staff with another industry group. Jane A. Sargent, *Pressure Group Development in the EC: The Role of the British Bankers' Association*, 20 J. COMMON MKT. STUD. 269, 271 (1982).

18. *Historical Perspective,* BBA LIBOR, http://www.bbalibor.com/explained/historical-perspective (last visited June 9, 2013). LIBOR is, of course, best known to most people as the site of probable manipulation. *See infra* notes 39–44.

19. *See, e.g.*, Michael Fleming et al., *An Analysis of OTC Interest Rate Derivatives Transactions: Implications for Public Reporting*, 557 FED. RESERVE BANK OF N.Y. STAFF REPORTS 1, 12 (Oct. 2012), http://www.newyorkfed.org/research/staff_reports/sr557.pdf.

20. Anna Gelpern, Commentary, *Contracts as Organizations*, 51 ARIZ. L. REV. 57, 63–64 (2009) (citing *ISDA Staff Information*, ISDA, http://isda.org/wwa/staff.html (last visited Feb. 5, 2009)) ("During the summer of 2008, ISDA had a staff of about seventy, most of them in New York and London."). BBA LIBOR has always had a staff in the low single-digits.

B. *The Dominant Narrative*

Despite a growing chorus claiming that the OTC derivatives market has been subject to private regulation,[21] much discussion of this market has generally assumed that it was essentially unregulated, or subject to rapid wholesale deregulation — and regulatory inactivity where regulation was possible[22] — on both sides of the Atlantic.[23] This version of history has familiar milestones. In 1989, the U.S. Commodity Futures Trading Commision (CFTC) provided a "safe harbor" from regulation for most OTC swaps.[24] In 1992, Congress followed suit and gave the CFTC general exemptive power over swaps.[25] At that time, the size of the OTC market was about $12 trillion, notional, excluding the foreign exchange market.[26]

In 1993, Metallgeschaft AG, Germany's fourteenth-largest corporation, lost $1.3 billion in derivatives transactions.[27] That same year, a G30 report on the OTC market advised no new state regulation, but instead provided extensive commentary on best practices that the private sector itself could implement.[28] That report was directed by officers at JP Morgan, ISDA, and others.[29]

The cornerstone of the deregulatory narrative was laid in the late 1990s. In a momentary reversal of the trend up until this point, the CFTC issued a Concept Release announcing its intentions to increase scrutiny of OTC derivatives in 1998.[30] The reaction was swift. Congress responded with the Commodity Futures Modernization Act (CFMA), enacted in 2000,[31] which is typically characterized as a "sweeping deregulation of OTC derivative

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21. *See infra* Part I.D.

22. Dan Awrey, *The FSA, Integrated Regulation, and the Curious Case of OTC Derivatives*, 13 U. PA. J. BUS. L. 1, 33 (2010) ("Not surprisingly, the enactment of the [Commodity Futures Modernization Act] ushered in a period of relative inactivity in the U.S. with respect to the regulation of OTC derivatives markets. This regulatory stasis stood in stark contrast, however, with the precipitous growth and proliferation of OTC derivatives markets.").

23. *Id.* at 46–47 (The U.K.'s Financial Services Authority is also non-interventionist).

24. Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694, 30,694–95 (July 21, 1989).

25. Futures Trading Practices Act of 1992, Pub. L. No. 102-546, § 502, 106 Stat. 3590 (1992).

26. U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-94-133, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 34 (1994).

27. ROBERT M. CONROY, MG REFINING & MARKETING, INC. (A) 1 (Univ. of Va., Darden Graduate Sch. of Bus. Admin. ed., 1998 rev. 2000), *available at* http://faculty.darden.virginia.edu/conroyb/IESE/2002/f-1227.pdf; ANAND SHETTY & JOHN MANLEY, METALLGESELLSCHAFT'S HEDGING DEBACLE 2, *available at* http://userwww.sfsu.edu/ibec/papers/39.pdf (last visited June 8, 2013).

28. WORKING GRP. ON GLOBAL DERIVATIVES, DERIVATIVES PRACTICES AND PRINCIPLES (1993) [hereinafter G30 PAPER].

29. *Id.* at *7.

30. *See* COMMODITY FUTURES TRADING COMM'N, OVER-THE-COUNTER DERIVATIVES (1998), *available at* http://www.cftc.gov/opa/press98/opamntn.htm.

31. Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554 § 1(a)(5), app. E § 1(a), 114 Stat. 2763, 2763A-366 (2000).

activity."[32] Among other things, the CFMA specified that OTC swaps between sophisticated parties could be transacted off of regulated exchanges and exempt from most of the Commodity Exchange Act.

Turf wars between the Securities and Exchange Commission (SEC) and CFTC may have also contributed to a lack of aggressive governmental regulation.[33] From its founding, the CFTC and the SEC were at odds about the proper shape and distribution of regulation in their respective areas, as well as the borders of those jurisdictions. In 1982, the Shad–Johnson Accord, named for the agency heads who helped cobble together an uneasy truce, gave regulatory authority over options on individual securities to the SEC and the rest to the CFTC.[34] This trend of governmental inaction has also been explained by large lobbying expenditures by the finance industry,[35] which succeeded in spreading a pro-financial innovation ideology and beating back regulation wherever it could.

This apparent absence of regulation of financial instruments generally,[36] and of derivatives in particular, has been cited as a major catalyst of the global financial crisis.[37] Without regulation, derivatives users were free to take imprudent risks, sometimes with the encouragement of brokers and advisors who may not have held their clients' interests very highly.[38] With the proliferation of an infinite variety of bespoke derivatives, it became increasingly difficult to assess one's indirect exposure to the failure of a counterparty's counterparty. The results of these trends were daisy chains of risk and a reduction of available credit. As Professor Stout has put it, "[i]t was the deregulation of financial derivatives that brought the banking system to its knees."[39]

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32. Baker, *supra* note 9, at 1299.

33. *See* Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, the United Kingdom, and Japan*, 28 BROOK. J. INT'L L. 319, 356–66 (2003); RECHTSHAFFEN, *supra* note 3, at 195 (describing jurisdictional disputes between the CFTC and SEC).

34. RECHTSHAFFEN, *supra* note 3, at 195.

35. Baker, *supra* note 9, at 1311.

36. Joseph E. Stiglitz, *Listen to the IMF, America*, SLATE (May 5, 2011, 1:04 PM), http://www.slate.com/articles/business/project_syndicate/2011/05/listen_to_the_imf_america.single.html ("Financial deregulation in the United States was a prime cause of the global crisis that erupted in 2008 . . . .").

37. *See* Krippel, *supra* note 14, at 278; *see also* FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at 52–66 (describing various deregulatory changes and arguing they causally contributed to the financial crisis).

38. For example, consider the now-infamous Abacus transaction. *See* Press Release, U.S. Sec. & Exch. Comm'n, Goldman Sachs to Pay Record $550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (July 15, 2010), *available at* http://www.sec.gov/news/press/2010/2010-123.htm.

39. Lynn A. Stout, *How Deregulating Derivatives Led to Disaster, and Why Re-Regulating Them Can Prevent Another*, LOMBARD STREET, July 6, 2009, at 4, http://www.finreg21.com/files/finreg21-finreg21/Lombard%207.pdf.

A similar story of deregulation (and disaster) is also frequently told about the most important interest-rate benchmark in the world — LIBOR. It is by now well known that at least one of the major banks contributing to the setting of LIBOR also manipulated it.[40] This manipulation was possible in part because of the way that LIBOR was compiled: each day, the BBA would ask six or more large banks "at what rate could you borrow funds . . . in a reasonable market size just prior to 11 am?"[41] The BBA discarded the top and bottom quartile of answers and averaged the remaining answers. This trimmed mean methodology was meant to eliminate problematic outliers from this benchmark of bank borrowing costs, but no data was required to substantiate banks' answers to this broad question, and there was clearly opportunity for an answering bank to tailor its response in order to influence the average. The deregulatory narrative suggests that the manipulation of LIBOR was due to the fact that it was unregulated,[42] and that mischief has thrived in the vacuum of regulation since the early days of LIBOR.[43] It does seem that there was no clear civil and criminal liability applicable to benchmark manipulation in the United Kingdom,[44] or in most other jurisdictions.[45]

Private or poor regulation, however, is not deregulation, and only by appreciating the OTC derivatives space in its full complexity can an optimal regulatory strategy be designed. In the next Section, we lay out the

40. Others have admitted that their employees *attempted* to manipulate LIBOR. *See generally*, Gabriel Rauterberg & Andrew Verstein, *Index Theory: The Law, Promise and Failure of Financial Indices*, 30 YALE J. ON REG. 101 (2012).

41. *The Basics*, BBA LIBOR, http://www.bbalibor.com/explained/the-basics (last visited June 11, 2013).

42. *See, e.g.*, Francesco Guerrera, *What's Next to Watch in Libor Drama*, WALL ST. J. ONLINE (July 9, 2012, 7:46 PM), http://online.wsj.com/article/SB10001424052702303567704577516450784443534.html (calling LIBOR a "once-unregulated process"); Damian Reece, *Record Fines for Barclays Are Just the Beginning of the Libor Scandal*, TELEGRAPH (June 27, 2012, 8:58 PM), http://www.telegraph.co.uk/finance/comment/damianreece/9360672/Record-fines-for-Barclays-are-just-the-beginning-of-the-Libor-scandal.html ("[I]t's surprising that setting the rate for [LIBOR] is unregulated."); Hibah Yousuf, *Pressing the Reset Button on Libor*, CNN MONEY (Sept. 27, 2012, 7:01 PM), http://money.cnn.com/2012/09/27/investing/libor-wheatley/index.html (quoting Martin Wheatley as stating that, "[i]n hindsight, it now appears untenable for such an important process to be unregulated.").

43. *See, e.g.*, Sean Vanatta, *Libor's Risks Emerged from Clubby London Banking Culture*, BLOOMBERG (Aug. 14, 2012, 1:58 PM), http://www.bloomberg.com/news/2012-08-14/libor-s-risks-emerged-from-clubby-london-banking-culture.html (arguing that manipulation of "Libor," as a general term for interbank lending rates, predates the BBA LIBOR now used); *see also* Mary Campbell, *Euromarkets in Low Gear*, FIN. TIMES, Sept. 16, 1974, at 26 ("Bank A agrees to quote a slightly above realistic LIBOR for the purposes of fixing the rate payable by a customer of bank B — on the understanding that bank B will do the same for bank A when the time comes.").

44. HM TREASURY, THE WHEATLEY REVIEW OF LIBOR: FINAL REPORT ¶ 2.30 (2012), *available at* http://cdn.hm-treasury.gov.uk/wheatley_review_libor_finalreport_280912.pdf [hereinafter THE WHEATLEY REVIEW].

45. *See, e.g.*, INT'L ORG. OF SEC. COMM'NS, *Discussion Paper on Benchmarks* (on file with author).

scholarly literature that has emerged concerning the reality of regulation by non-state and private actors.

C. *Governance Outside the State*

In October 2012, the U.K. government adopted a proposal that panel bank submissions for the LIBOR rate should be unavailable to the public for three months.[46] The motivation behind the proposal was that initial submission anonymity would permit contributor banks to more frankly represent their cost of borrowing, and the U.K. government's move represented a paradigmatic attempt at incremental financial regulation. More than four years earlier, the BBA had considered the same proposal for the same reason. The BBA controlled the LIBOR-setting mechanism and easily could have imposed the same scheme.[47] If it had, it would have in most respects been functionally identical in its operation, and it would have similarly represented financial regulation, albeit by a private non-profit rather than by a government.

The functional consequences of a supervisory directive can be identical irrespective of whether the state or a private actor imposes it. Indeed, the reality that rule-making for private entities by a non-governmental institution can be regulation is widely acknowledged and allows for a far richer and subtler analysis of the regulation applicable to any particular arena of our financial markets. As Ian Ayres and John Braithwaite put it over twenty years ago, "the intellectual stalemate between those who favor strong state regulation of business and those who advocate deregulation" is pejoratively academic, because financial participants themselves realized that "regulation occurs in 'many rooms'" and that "good regulatory policy [involved] acceptance of the inevitability of some sort of symbiosis between state regulation and self-regulation."[48] Different forms of this broadened perspective on regulation have taken on various names across time, from Reisman's celebration of the New Haven School[49] to more recent New Governance scholarship.[50]

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46. Press Release, HM Treasury, Gov't Accepts Recommendations from the Wheatley Review of LIBOR in Full (Oct. 17, 2012), *available at* https://www.gov.uk/government/news/government-accepts-recommendations-from-the-wheatley-review-of-libor-in-full; *see also* THE WHEATLEY REVIEW, *supra* note 44, ¶ 5.15. ("Real-time publication of submissions can create incentives to submit a lower rate than would otherwise have been submitted."). We will explore this proposal in greater detail along with other relevant portions of the Wheatley Review.

47. BRITISH BANKERS' ASS'N, BBA LIBOR CONSULTATION FEEDBACK STATEMENT (2008) [hereinafter BRITISH BANKERS' ASS'N, BBA LIBOR CONSULTATION], *available at* http://www.bba.org.uk/media/article/bba-libor-review-consultation-feedback-statement/latest-news.

48. IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE 3 (1992).

49. W. Michael Reisman, *International Law-making: A Process of Communication*, 75 AM. SOC'Y INT'L L. PROC. 101, 107 (1981) (New Haven School "liberates the inquirer from the limiting and . . .

Applications of this approach to private financial regulation have already born fruit. Janet Koven Levit has explored an international trade finance regime under the banner of what she calls "[b]ottom-up lawmaking . . . [which does] not feature state policymakers but rather the very practitioners — both public and private — who must roll up their sleeves and grapple with the day-to-day technicalities of their trade."[51] A process can become functionally regulated even where no sovereign authoritatively imposes the norms and practices.

D. Transnational Private Regulation of the OTC Derivatives Market

ISDA is well-recognized as a transnational private regulator. Indeed, noting this feature has been one of the first and principal insights of almost every scholar to survey the terrain of OTC derivatives.[52] Some have observed the private governance character of the OTC derivatives market and have attempted to place it in a broader theoretical perspective. Professor Baker has noted that "the Credit Derivative Determination Committees of [ISDA] exemplify the highly successful and rapid growth

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distorting model of positivism, which holds that law is made by the legislature," but includes "any communication between elites and politically relevant groups which shapes wide expectations about appropriate future behavior."); *see also* Harold Hongju Koh, *Why Do Nations Obey International Law?*, 106 YALE L.J. 2599, 2622 n.110 (1997).

50. *See, e.g.*, Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 417 (2011) ("The New Governance scholarship posits, generally, that the traditional top-down model of regulation, in which the power to create rules belongs exclusively to the state, is being replaced by a more flexible 'governance' model, in which power to set and enforce the rules is increasingly diffused among a variety of societal actors working alongside the governments."); Robert F. Weber, *New Governance, Financial Regulation, and Challenges to Legitimacy: The Example of the Internal Models Approach to Capital Adequacy Regulation*, 62 ADMIN. L. REV. 783, 786 (2010).

51. Janet Koven Levit, *A Bottom-Up Approach to International Lawmaking: The Tale of Three Trade Finance Instruments*, 30 YALE J. INT'L L. 125, 126 (2005); *see also* Peer Zumbansen, *The Ins and Outs of Transnational Private Regulatory Governance: Legitimacy, Accountability, Effectiveness and a New Concept of "Context,"* 13 GERMAN L.J. 1269, 1278–79 (2012) ("Faced with a multitude of overlapping, fast-evolving private regulatory governance regimes in areas ranging from financial to environmental regulation, investment law or commercial transfers, lawyers must continue to both expand their expertise with regard to specialized, technical transactional areas and appreciate the relevance of non-legal ordering and regulatory concepts which underlie and inform many of the emerging governance regimes.").

52. *See, e.g.*, Georgette Chapman Phillips, *The Jumbled Alphabet Soup of the Collapsed Home Mortgage Market: ABCP, CDO, CDS and RMBS*, 18 U. MIAMI BUS. L. REV. 143, 179 (2010) ("[A]s a self-regulating industry under the purview of the International Swaps and Derivatives Association, the derivatives market is a miserable failure."); Colin Scott, *Beyond Taxonomies of Private Authority in Transnational Regulation*, 13 GERMAN L.J. 1326, 1329 (2012) (discussing ISDA's standard-creating process as transnational private regulation); Aaron Unterman, *Perverse Incentives: Risk Taking and Reform*, BANKING & FIN. SERVICES POL'Y REP., June 2009, at 11, 19–20 ("The derivatives market has grown to astonishing heights as a self-regulating industry under the purview of the International Swaps and Derivatives Association (ISDA).").

of global private governance of the OTC derivative markets."[53] Professor Biggins has echoed ISDA's accomplishments in discussing its successful standardization of OTC derivatives contracts, which has "result[ed] in the creation and sustenance of a highly successful transnational private regulatory regime."[54] Similarly, Professor Omarova, while arguing for a new, more comprehensive understanding of financial self-regulation in the wake of the financial crisis, used ISDA's creation of standardized contracts for OTC derivatives transactions as a "leading example of . . . efficiency-enhancing private industry self-regulation in today's financial markets."[55] Professor Howell said that the swap market "has functioned surprisingly well and constitutes what must be regarded as a premier example of private regulation in financial markets."[56] Others have discussed private regulation as the *sole* regulatory force in parts of the derivatives markets, essentially replacing international regulatory agencies with the actual market participants.[57]

ISDA and the BBA's roles as transnational private regulators can be seen in its inputs (market constituents forming bureaucracies to design governing rules, mirroring and working alongside state regulation), outputs (regulatory directives and standardized documentation), results (a harmonized and partially regulated market), and the way in which state actors have deferred to them. ISDA has successfully imposed upon the market a remarkable degree of regulation and harmonization of practices. From the beginning, ISDA worked with the G30 to draw up detailed best practices guidelines for the swap business.[58] ISDA has also helped to constrain insider trading in the derivatives space.[59]

ISDA's most important contribution has been the creation of its standard form documents.[60] The earliest iteration came in the 1985 Swaps

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53. Baker, *supra* note 9, at 1296.

54. John Biggins, *'Targeted Touchdown' and 'Partial Liftoff': Post-Crisis Dispute Resolution in the OTC Derivatives Markets and the Challenge for ISDA*, 13 GERMAN L.J. 1297, 1297 (2012).

55. Omarova, *supra* note 500, at 444.

56. Jackson E. Howell, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES IN LAW 649, 665–66 (2001).

57. *See, e.g.*, 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, 188–89 (2009) ("[T]here is no international regulatory agency that directly monitors or regulates the CDS market . . . . [T]he true regulators of the CDS market are the participants themselves."); *id.* at 192 (discussing "ISDA's self-regulatory system"); *see also* Paul Lejot, *Cover Up! Hong Kong's Regulation of Exchange-Traded Warrants*¸ 36 H.K. L.J. 277, 279 (2006) (discussing ISDA as the OTC derivatives market's self-regulatory organization and its documentation-creating role).

58. *See, e.g.*, G30 PAPER, *supra* note 28; GILLIAN TETT, FOOL'S GOLD: THE INSIDE STORY OF J.P. MORGAN AND HOW WALL ST. GREED CORRUPTED ITS BOLD DREAM AND CREATED A FINANCIAL CATASTROPHE 35 (2010).

59. *See, e.g.*, Serena Ng, *Trading Groups Are Agitating over Apparent Leaks on Street*, WALL ST. J., Dec. 14, 2006, at C3.

60. *See, e.g.*, Barry Le Vine, C*omment: The Derivative Market's Black Sheep, Regulation of Non-Cleared*

Code, abbreviated from the Code of Standard Wording, Assumption and Provisions for Swaps.[61] Newer versions of the documentation contain three components: the Master Agreement, where harmony lies and all the standard terms reside; the Schedule, which modifies the Master Agreement where choices are to be made; and the Confirmation, which covers the details of the instant transaction. Other documents are also commonly appended, such as collateral documents, bridging documents, which provide for netting across all ISDA documented transactions between the parties, and other definitions. Though other bodies have offered standard documents,[62] the ISDA Master Agreement is used in more than ninety percent of OTC derivative transactions.[63] These standard documents have been called a "modern international law merchant."[64] Without these standard documents, "parties would be plagued by arduous negotiation."[65]

ISDA's process of updating and implementing these documents has numerous regulatory characteristics. ISDA employs about 3000 people in its documentation committee,[66] which reacts quickly to modify documents — striking and redefining terms — to remain efficient as legal and economic circumstances change.[67] This process also preserves international harmony of treatment. For example, the 1992 version of the ISDA Master Agreement provided a thirty-day cure period during which a debtor might contest involuntary bankruptcy and thereby avoid the characterization of "default."[68] The 2002 version shortens this period to fifteen days.[69] Some practitioners have criticized this durational shift, emphasizing that it can take more than fifteen days to even issue a summons in an involuntary bankruptcy, if only because of a "dilatory clerk."[70] Yet this shorter rule provides international certainty that is largely immune from domestic variation in bureaucratic delay.

Security-Based Swaps Under Dodd–Frank, 31 NW. J. INT'L L. & BUS. 699, 710–11 (2011) (noting "significant operational standardization that has taken place over the past five years, such as harmonization of default criteria in master ISDA agreements.").

61. *See, e.g.*, Norman Menachem Feder, *Deconstructing Over-the-Counter Derivatives*, 2002 COLUM. BUS. L. REV. 677, 737 (2002).

62. *Id.* at 740.

63. *See, e.g.*, Henry Knox, *Master Artfulness*, THE LAWYER (Mar. 7, 2011), http://www.thelawyer.com/master-artfulness/1007152.article.

64. Tamar Frankel, *Cross-Border Securitization: Without Law, But Not Lawless*, 8 DUKE J. COMP. & INT'L. L. 255, 275 n.56 (1998).

65. 6 THOMAS J. MOLONEY ET AL., BUSINESS & COMMERCIAL LITIGATION IN FEDERAL COURTS § 70:17 (Robert L. Haig ed., 3d ed. 2012); *see also* Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 HARV. NEGOT. L. REV. 211 (2001).

66. Gelpern, *supra* note 20, at 65–66.

67. Stephen J. Choi & G. Mitu Gulati, *Contract as Statute*, 104 MICH. L. REV. 1129, 1144 (2006).

68. INT'L SWAPS & DERIVATIVES ASS'N, 1992 ISDA MASTER AGREEMENT, § 5(a)(vii)(4) (1992).

69. INT'L SWAPS & DERIVATIVES ASS'N, 2002 ISDA MASTER AGREEMENT, § 5(a)(vii)(4) (2002).

70. Mark D. Sherrill, *Involuntary Bankruptcy and the ISDA Master Agreement: A Square Peg and a Round*

Though scholars have often described the ways in which legislatures will respond to clear judicial determinations to confirm or override judicial decisions, we observe little of this dialogue in practice.[71] By contrast, transnational private regulators lead the state sector in harmonizing quasi-legislation with an iterative interpretation process. For example, the 2002 version of the ISDA Master Agreement provides in Part (2)(a)(iii) that a non-defaulting party can withhold payments to a defaulting party during the period of default, creating a valuable option that *permits* the non-defaulting party to maintain its claim. The question in the *Lomas* case was how long can the non-defaulting party wait.[72] Forever? Until the next payment date?[73] Or until the natural end of the transaction?[74] ISDA supported giving the non-defaulting party essentially unlimited time to revive its claim,[75] while some prior decisions had suggested shorter "use it or lose it" rules. Recent judicial decisions have clarified the clause consistently with ISDA's suggestion. But ISDA is contemplating an amendment to clarify the clause in any case, and perhaps even to contradict its prior position now that its constituents can evaluate a clear rule. This illustrates that ISDA is legislative and in dialogue with the courts.

Through the use of protocols, ISDA is able to update contracts on an ongoing basis.[76] Protocols are multilateral contractual amendments, drafted by ISDA, which then solicits letters of adherence from swap participants. When all parties to a swap accept the protocol, the protocol becomes binding on the parties, allowing them to assent contingently to multiple contract amendments at once.[77] This is much the same way as Delaware's legislature and courts are able to update the default corporate form from time to time, retroactively modifying the guiding documents for Delaware incorporated firms.[78] In other words, ISDA is a forum for the provision of authoritative directives with quasi-precedential force.

ISDA also functions as a sort of adjudicator through the use of its Credit Determinations Committees.[79] Key terms, such as "default" in a

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Hole, AM. BANKR. INST. J., Apr. 2008, at 1, 60 (citing Windbrooke Dev. Corp. v. Envtl. Enters., Inc. of Fla., 524 F.2d 461 (5th Cir. 1975)).

71. *See* David Marcus, *Trans-Substantivity and the Process of American Law* (Univ. of Ariz. James E. Rogers Coll. of Law, Discussion Paper No. 13-12, 2013), *available at* http://ssrn.com/abstract=2220505.

72. Lomas v. JFB Firth Rixson, Inc., [2010] EWHC 3372 (Ch).

73. Marine Trade S.A. v. Pioneer Freight Futures Co. BVI, [2009] EWHC 2656 (Comm).

74. *Lomas*, [2010] EWHC 3372 (Ch).

75. *Id.*

76. *See, e.g.*, Andrew Verstein, *Ex Tempore Contracting*, § III(B) (Yale Law & Econ., Research Paper No. 545, 2012), *available at* http://ssrn.com/abstract=2125169.

77. *About ISDA Protocols*, ISDA, http://www2.isda.org/functional-areas/protocol-management/about-isda-protocols/ (last visited June 2, 2013).

78. *See, e.g.*, Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1 (2006).

79. *See* Verstein, *supra* note 76; *see also* Anna Gelpern & G. Mitu Gulati, *CDS Zombies* (Am. Univ.

credit default swap (CDS), cannot be described in granular detail *ex ante*, so ISDA contracts specify that a Credit Determinations Committee will have the power to define any such term. Thus, when parties want contractual clarity, any party can make a request to the appropriate committee to define the contractual term. In some cases, this amounts to a determination as to whether the CDS is or is not in default at the present time. These determinations can be fast, giving parties clarity as to their entitlements in near real-time. They can then move to seize collateral, renegotiate, or litigate as need be. Because these determinations are binding on the contract but not enforceable as judgments, and are based on general facts about the contract and the market rather than specific investigations of a party-specific dispute, they are akin to administrative proceedings rather than outright adjudication. In the absence of speedy, trustworthy courts for arbitration, the market's need for timely determination is met by a non-state actor. Just as norms can be promulgated by a transnational private regulator, rather than a legislature, they can be adjudged by a transnational private regulator rather than a court.

In addition to playing legislative and judicial roles, ISDA materials are frequently incorporated in state law and regulation. Sometimes, legislative materials refer to ISDA and its documentation by name, such as when the New York Insurance Law specifically mentions ISDA documentation in the definition of a credit default swap.[80] Usually, incorporation is not by name.[81] Yet, nameless reference can be equally powerful, such as when the Bankruptcy Code defines a swap by way of a Master Agreement.[82] Incorporation of this ISDA innovation, though without ISDA's name on it, is part of how domestic law implements international norms of netting. And, of course, ISDA's pervasive role in structuring the shape of the OTC space — the space that is largely exempt from the Commodity Exchange Act — is not mentioned in any such statute or rule.[83]

State reliance on, and reference to, the ISDA regime is consistent with Cunningham's analysis of the public implementation of private standards into law. [84] Cunningham discusses different forms of interaction between formal state law and private governance norms. He identifies three levels of state recognition of private norms: (1) when the law merely mentions

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Wash. Coll. of Law, Working Paper No. 2012-37, 2012).

80. N.Y. INS. LAW § 6901(j)(1) (McKinney 2005); *see also id.* at (g)(5)(A)(ii) (defining collateral in terms of ISDA documentation).

81. *See, e.g.*, Frank Partnoy, *Second-Order Benefits from Standards*, 48 B.C. L. REV. 169, 186 (2007).

82. 11 U.S.C.A. § 53B(v) (West 2013).

83. *See, e.g.*, Partnoy, *supra* note 81, at 186.

84. Lawrence A. Cunningham, *Private Standards in Public Law: Copyright, Lawmaking and the Case of Accounting*, 104 MICH. L. REV. 291 (2005) (creating a typology for different types of private standards used in law).

private norms, (2) when the law incorporates private norms into law after their creation, and (3) when the law formally recognizes a private body as a state-endorsed standards creator.[85] ISDA and the BBA, as will be discussed below, operate principally at the first two of these levels. Partnoy similarly analyzes the OTC space: "[O]ne might argue that Congress implemented a de facto strong standards regime, relying on ISDA, based on ISDA's dominance at the time."[86] Partnoy surveys evidence of the strength of ISDA's standards and their direct incorporation into law, as well as the law's sometimes-silent reliance on those standards.[87] As an example of the former, there are a large number of legal decisions relying on ISDA; as an example of the latter, globally there are a vast number of statutes and regulations that reflect provisions of ISDA form contracts, but do not mention ISDA by name.[88]

No doubt, some of this incorporation reflects the influence ISDA has had in shaping state regulation.[89] But even ISDA's influence on state regulation does not imply a passive, deregulatory state. States can sometimes stoop to conquer. If ISDA is known to have a harmonizing, rationalizing agenda, states know that rendering themselves open to ISDA's influence will tend to advance harmonized, rational governance. The passive stance toward ISDA can be an active stance toward the OTC derivatives market.

By comparison, the BBA's operation as a private regulator with international power has gone remarkably unnoticed,[90] especially when the prominence of LIBOR in the last year is taken into account. Nonetheless, its regulatory role is undeniable. Like ISDA, the BBA's most important contribution to the OTC derivatives market is as a harmonizing force within its sector. ISDA created a viable and harmonized set of terms for agreements,[91] but in the early days of interest-rate swaps, "nonuniformity was a significant problem" in price as well.[92] Difficulty agreeing upon a

85. *Id.* at 293.
86. Partnoy, *supra* note 81, at 187.
87. *Id.*
88. *Id.*
89. G30 REPORT, *supra* note 28.
90. It is easy to focus on anti-regulatory activity. The BBA's founding activity was resisting harmonization at the pan-European level, and, in general, state and inter-state regulation and harmonization wherever possible. *Notebook International: Brussels: Initiative Required*, 123 THE BANKER 1421, at 1421 (Dec. 1973) ("harmonization should be limited to as few issues as possible and be based on the principles of maximum flexibility and self-regulation."). Yet even as the BBA resisted governmental harmonization efforts, it worked to rationalize the norms of a disorderly banking landscape.
91. Interestingly, the BBA drafted the first model swap agreement, which was quickly superseded by ISDA documentation. *See, e.g.*, Vanatta, *supra* note 43.
92. *Id.*

rate within a given document could be a major sticking point in a negotiation. As Jeffrey Golden put it:

> Market participants fought about everything, even the fallback rate. That is to say there were pitched battles about what the rate would be and how it would be determined if it was impossible to find a reference bank in London that would quote an offered rate for deposits in the interbank market. Do you go to another market, and, if so, which one? Do you seek quotations from one, three or five reference banks in that market?[93]

There are also large network benefits associated with using a single price in many transactions. Some of these benefits are the same as with non-price terms: Common terms make it easier to find a third party willing to assume one's responsibilities and more likely that a court will honor those responsibilities; common terms create liquidity through ease of use and standardization; and common terms eliminate transaction costs. But price commands an additional reason for widespread use, because when a price term is well-known financial actors can generate extensive knowledge about the rate and its relation to their other options and positions. LIBOR is sufficiently well-known that financial models predict its motion in relation to other benchmarks, and parties are likely to have multiple LIBOR exposures to which they can relate the newly contemplated swap. They can minimize basis risk with little difficulty, rather than trying to estimate how a non-LIBOR rate might link with their other exposures.

Like ISDA, the BBA's role as a transnational regulator has been both reflected and endorsed through governmental decisions. Indeed, LIBOR's ubiquity arose in part through the choices of state agents. Courts have long adverted to LIBOR in their assessment of damages.[94] Many laws require or prefer the use of a well-known index, and parties who select LIBOR are essentially granted a safe harbor due to judicial and administrative preferences.[95] For example, the Parity Act allows non-federally chartered housing creditors to lend with adjustable rates, provided that they use "a national or regional index,"[96] which the Office

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93. Jeffrey B. Golden, *Setting Standards in the Evolution of Swap Documentation*, 13 INT'L FIN. L. REV. 18 (1994). Golden actually refers to "Libor" in the foregoing, but means by it only a generic term for *an* interest rate benchmark, not the BBA LIBOR that would come to be synonymous with LIBOR.

94. *See, e.g.*, Rose Hall, Ltd. v. Chase Manhattan Overseas Banking Corp., 566 F. Supp. 1558, 1579 (D. Del. 1983) ("In such cases, the rate employed has been the average borrowing rate an average plaintiff would have had to pay to receive the same amount of money . . . . It follows that the LIBOR rate, which represents the cost of borrowing US$ (the currency at issue here) should be utilized in this case.").

95. Stein v. JP Morgan Chase Bank, 279 F. Supp. 2d 286, 290 (taking judicial notice of interest rates of indexes published in the Wall Street Journal).

96. McCarthy v. Option One Mortg. Corp., 362 F.3d 1008, 1013 (7th Cir. 2004) (discussing the Alternative Mortgage Transaction Parity Act of 1982, Title VIII of the Garn-St. Germain Depository

of the Comptroller of the Currency and courts have consistently found LIBOR to be.[97]

State actors also use LIBOR in their own transactions. U.S. regulators used LIBOR as a key rate in making loans to troubled firms during the financial crisis, such as the Federal Reserve and the Treasury's bailout loans to AIG.[98] Furthermore, LIBOR is the Department of Commerce's preferred rate when engaging in foreign currency transactions.[99] This is consistent with the notion that powerful network effects are often established (or exacerbated) by public institutions.[100] But it also shows the ways in which powerful private governance exists as an extension of, and in conversation with, the public regulatory state, such as the way in which the U.S. government deferred to credit rating agencies and incorporated them into law.[101]

Considering its origin as a private institution, it is interesting just how public a character and outlook the BBA's LIBOR regulation has assumed. Prior to the widespread allegations of manipulation in 2007, 2008, and 2011, the BBA initiated major efforts to formalize and professionalize its governance activities. These efforts are what John Ewan, former director of LIBOR, called his most important early task at the BBA.[102] He set about formalizing a set of rules for rate calculation, data contribution, and determination of veracity. The BBA enacted and clarified rules requiring certification of contributor banks' processes by their own auditor and risk management or compliance department. Without legal coercion, the BBA adopted a set of regulations that aimed at improving veracity.

These safeguards were obviously inadequate. Yet, when news broke indicating that these efforts may have been insufficient to prevent manipulation, the BBA initiated a consultative inquiry as to how the LIBOR rate could be rendered more useful and secure. The 2008 consultation was released in December of that year.[103]

Institutions Act of 1982, 12 U.S.C. § 3801(a)(1)).

97. *See id.*

98. *See, e.g.*, Mark Gongloff, *Tim Geithner Admits Banks Bailed Out with Rigged Libor, Costing Taxpayers Huge Amount*, HUFFINGTON POST BUS. (July 25, 2012, 11:06 AM), http://www.huffingtonpost.com/mark-gongloff/timothy-geithner-libor_b_1701904.html.

99. Hornos Electronicos de Venezuela, S.A. v. U.S., 285 F. Supp. 2d 1353, 1369 (Ct. Int'l Trade 2003).

100. *See* DAVID SINGH GREWALL, NETWORK POWER: THE SOCIAL DYNAMICS OF GLOBALIZATION (2009).

101. Concerns of network power will also be especially apt where the value of harmonization to a market is especially significant, as many have recognized it to be in the OTC derivatives market. We thus should not neglect the BBA and ISDA's valuable (and dangerous) achievement in effectively becoming monopolists over two highly valuable public goods — the transactional structure of OTC derivative customization and the interest rate reference for short-term loans.

102. Interview with John Ewan, Former Dir. of LIBOR, British Bankers' Ass'n., in London (June 15, 2011) [hereinafter Interview with John Ewan].

103. *See generally* FX & MM COMMITTEE SECRETARIAT, LIBOR GOVERNANCE AND SCRUTINY:

The results of that process were modest changes to the governance structure. Chairs were created for additional constituencies, such as non-contributor banks in the United States and Europe, the principal options exchanges in the United States and London, and fund and corporate borrowers, to help administer the rate. As of January 2010, BBA LIBOR has also been governed by an independent board.[104]

These changes appear to have done little to stop subsequent attempts at manipulation from taking place. Procedures remained lax, chummy, informal, or ineffective. But this is not to say that there was no regulation. After all, the light touch approach — governance by stern looks, and the like — has long characterized English state governance as well.[105]

It is also interesting that the BBA's investigation appears to have considered nearly every option both suggested and implemented by subsequent state regulators.[106] Many of these options were rejected by the BBA, for reasons we may or may not accept. But they undeniably engaged in public rulemaking by interviewing the relevant constituencies and sharing the results of that inquiry and the reasons that guided them.

LIBOR assumed some public functions as the state sector increasingly withdrew from those functions. For example, until October 1979 the Federal Reserve took an interest in providing stable interest rates, and therefore concerned itself with reducing interest rate risk. Under Paul Volcker's leadership, the Federal Reserve shifted its focus to combating inflation in the real economy and allowing the federal funds rate to move as it might.[107] Interest rate volatility increased enormously and the market had to look away from government regulators for protection and stability. At the same time, a confluence of forces led to the rise of offshore interbank dollar funds, or Eurodollar deposits, as a source of financing.[108]

LIBOR provided banks with just such a tool to reduce volatility. Banks wishing to make long-term loans could provide LIBOR loans, a variable

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PROPOSALS AGREED BY THE FX & MM COMMITTEE (2008), *available at* http://www.bbalibor.com/download/4025.

104. *Governance*, BBA LIBOR, http://www.bbalibor.com/governance. Note, however, that the members of the board are secret.

105. *See, e.g.*, Alicia Davis Evans, *A Requiem for the Retail Investor?*, 95 VA. L. REV. 1105, 1110–11 n.24 (discussing whether U.K. regulation is appropriately described as "light touch").

106. *See* discussion *infra* Part II.A–C.

107. *See, e.g.*, David E. Lindsey et al., *The Reform of October 1979: How It Happened and Why*, 87 (2, part 2) FED. RESERVE BANK OF ST. LOUIS REV. 187 (2005), *available at* http://research.stlouisfed.org/publications/review/05/03/part2/Lindsey.pdf.

108. *See* Hugh S. Piggott, *The Historical Development of Syndicated Eurocurrency Loan Agreements*, 10 INT'L BUS. L. 199, 199 (1982) (arguing that interest rate caps on time deposits in America and interest prohibitions on demand deposits made raising funds in America more difficult); Philip R. Wood, *Essay: Sovereign Syndicated Bank Credits in the 1970s*, 73 LAW & CONTEMP. PROBS. 7, 8 (2010) (noting that interest-equalization tax discouraged loans outside of the United States, and that oil price hikes led to dollar outflows into overseas accounts).

rate loan that moved with their funding costs. Borrowers unwilling to accept the interest rate risk inherent in the loan could engage in swap transactions to receive an offsetting payment and pay a fixed rate. The variable liability could be reassigned to whomever was best able to accept interest rate risk. Financial engineering with LIBOR-priced loans and swaps became a source of interest rate stability at precisely the moment that the Federal Reserve withdrew from the task, allowing banks to lend at a rate reflecting their true cost of funds. This transition took place with the tacit approval of regulators.[109]

The history of the Commodity Futures Modernization Act's enactment also suggests that a government can decide to regulate through deploying a transnational private regulator. Some have gone as far as to suggest that ISDA basically drafted the CFMA — the legislation that created almost two decades of *de facto* exclusive regulatory jurisdiction of the OTC derivatives market for ISDA. As one author put it, Senators Lugar and Gramm "quietly inserted this 262-page bill (written by the ISDA) into a $384 billion, 11,000-page omnibus budget bill."[110] Indeed, the role of ISDA may have been even stronger.

ISDA lobbied successfully for enactment of the U.S. Commodity Futures Modernization Act in 2000, which exempted OTC derivatives from regulation by the federal agency that supervises futures and commodities exchanges. ISDA's skill in promoting standardization in swap market practice, documentation, and settlement was important in this decision, and effectively ended pressure for direct regulation of OTC derivative products, both in the United States and elsewhere.[111]

Frank Partnoy draws something like the same causal connection in the context of ISDA's important role as a standards-setting organization.[112] As he puts it, "one might argue that Congress implemented a de facto strong standards regime, relying on ISDA, based on ISDA's dominance at the time. Judicial reliance on ISDA standards would support such a strong

109. Hillbrandt, ICI's finance director, asserts that the Bank of England was briefed on the use of swaps to facilitate the Eurodollar market and was "favorably inclined to the use of swap arrangements of this type." Raphael Hodgson, *The Birth of the Swap*, 65 FIN. ANALYSTS J. 32, 34 (2009).

110. Mark Labaton, *Swap Meet: An Understanding of the Development of Credit Default Swaps Can Point the Way to Real Financial Industry Regulatory Reform*, LOS ANGELES LAWYER, Oct. 2009, at 24, 28, *available at* http://www.lacba.org/Files/LAL/Vol32No7/2637.pdf.

111. Lejot, *supra* note 57, at 292–93 ("ISDA lobbied successfully for enactment of the US Commodity Futures Modernization Act in 2000, which exempted OTC derivatives from regulation by the federal agency that supervises futures and commodities exchanges. ISDA's skill in promoting standardisation in swap market practice, documentation and settlement was important in this decision, and effectively ended pressure for direct regulation of OTC derivative products, both in the United States and elsewhere.").

112. *See, e.g.*, Partnoy, *supra* note 81, at 187.

interpretation. More than eighty published cases have relied on ISDA in reaching decisions."[113]

The foregoing is not an argument that ISDA or the BBA have been consistently *excellent* regulators. Numerous complaints can be made, from the manipulation of LIBOR to the backlog in derivatives confirmations.[114] Though it can be rational for states to outsource regulation, the recipients of that power may be venal or inept; but they are still regulators. The next Part considers the implications of characterizing the OTC market as having been subject to private regulation.

II. IMPLICATIONS OF THE TRANSNATIONAL PRIVATE REGULATION OF THE OTC DERIVATIVES MARKET

A. Moderating Reactive Regulation

There is a well-documented process by which laws are written in great number and length in the wake of regulatory failure and crisis, and these laws may be unduly punitive, rushed, or otherwise problematic.[115] This phenomenon seems to be especially prevalent in the financial space.[116]

This is not just a pathology of lawmaking; once the deregulated status quo is accepted, new regulation stems from common sense. A new sweep of regulation may bring unanticipated problems, but who will decline the offer of "regulation" when the discredited alternative is "no regulation"?

Recognizing that the status quo *was* regulated may hold some promise of tempering this cycle. The regulation was insufficient, co-opted, corrupt, or mistaken, so reform is required. However, the resultant reform is from regulation to regulation, regulator to regulator, which necessarily involves a more sophisticated approach. Consider, in comparison, the criticism of thrift regulation under the Office of Thrift Supervision (OTS).

113. *Id.*

114. *See* Baker, *supra* note 9, at 1315; *see also* Siona Robin Listokin, *MetaRegulation of OTC Derivatives Contracts Post Reform* (Nov. 4, 2009), *available at* http://ssrn.com/abstract=1499964 (discussing industry's failure to address confirmation backlog).

115. STEPHEN M. BAINBRIDGE, CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS (2012); STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690–1860 257 (1998); Larry E. Ribstein, *Bubble Laws*, 40 HOU. L. REV. 77, 79 (2003); Mark J. Roe, *Washington and Delaware as Corporate Lawmakers*, 34 DEL. J. CORP. L. 1, 7 (2009); Roberta Romano, *The Sarbanes–Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1591–94 (2005).

116. *See, e.g.*, Lawrence A. Cunningham & David Zaring, *The Three or Four Approaches to Financial Regulation: A Cautionary Analysis Against Exuberance in Crisis Response*, 78 GEO. WASH. L. REV. 39, 74–89 (2009). For example, Bainbridge noted of our intellectual property proposal that "even if it had merit as a stand-alone reform, Rauterberg and Verstein's proposal surely was unrealistic in terms of practical politics." Stephen Bainbridge, *Reforming Libor: Wheatley Versus the Alternatives*, 45–50 (UCLA Sch. of Law, Law & Econ. Research Paper No. 13-02) *available at* http://ssrn.com/abstract=2209970.

Washington Mutual, AIG, Countrywide Financial and other prominent financial institutions held charters as thrifts, regulated by the OTS.[117] These institutions performed poorly during the financial crisis, having been allowed to binge on risky mortgage-backed instruments, swaps, and subprime assets.[118] The OTS was savagely criticized and then disbanded — the nuclear option in administrative discipline. We did not act, however, as though thrifts were roaming brigands, free from all regulation. We knew that they were regulated, but badly, and so we set about integrating them into a regulatory regime that made more sense.

If the problematic past had zero regulation, then it makes sense to think that any non-zero amount of regulation is likely to be an improvement. However, if the past was regulated, then any change is a *change* in regulation rather than an *initiation* of regulation. Proposals must be justified as superior to existing regulation rather than simply superior to no regulation. Substantively, this framing is likely to lead to more nuanced and moderate regulatory responses.

What would this more nuanced approach to regulatory reform look like? LIBOR's failure has prompted numerous reform proposals, some of which have been adopted, and some of which may yet be. It is nonsense to act as though these proposals are against a blank slate when most of these proposals were explicitly considered by the BBA. Even if that body has been discredited, it bears considering the arguments that might have justified resisting the proposals previously.

The Wheatley Review is a blue ribbon report prepared by Martin Wheatley, the CEO designate of the United Kingdom's soon-to-be new financial regulator, the Financial Conduct Authority (FCA). The FCA will have control over most non-stability related financial regulation.[119] Wheatley's September 2012 report made a series of proposals,[120] which the U.K. government has endorsed in full and has already begun to implement.[121] The recommendations suggest increased public oversight of the index (LIBOR), including substantive requirements for how the index must be created, and increased penalties for malfeasance.

Fascinatingly, almost all of the 2012 Wheatley reforms were considered by the BBA in its 2008 consultative paper. Many were rejected, often for reasons acknowledged by Wheatley in his reports. As regulators consider

117. *See* Dain C. Donelson & David Zaring, *Requiem for a Regulator: The Office of Thrift Supervision's Performance During the Financial Crisis*, 89 N.C. L. REV. 1777, 1779 n.5 (2011).

118. *See id.* at 1777 (evaluating relative performance of thrifts).

119. *See, e.g.*, Sam Robinson, *The Financial Conduct Authority — Its Role in the New UK Regulatory Framework*, BLOOMBERG LAW, http://about.bloomberglaw.com/practitioner-contributions/the-financial-conduct-authority/ (last visited Aug. 17, 2013).

120. THE WHEATLEY REVIEW, *supra* note 44.

121. *See, e.g.*, HM TREASURY, WRITTEN MINISTERIAL STATEMENT 2 (2012), *available at* http://www.hm-treasury.gov.uk/d/wms_fst_171012.pdf.

moving forward, they should take stock of the evaluation of their regulatory predecessor.

The BBA also considered changes to the index that might better serve the public, but declined to do so for avowedly public interest reasons. If taken at its word, the BBA's inaction was a deliberate regulatory decision. At a minimum, the BBA showed sophistication about what others would take to be its responsibility. Taking stock of the BBA report, the lesson is that with any reform effort, the reforms necessarily involve trade-offs that prior BBA regulatory consultations highlighted.[122] We will provide numerous examples of this later. For now, at least three trade-offs are notable in discussing any improvement of LIBOR:

(1) *Reform versus stability (or, the "grandfathering problem")*: Any proposal that makes important changes to the index will upset market expectations for those who began using the index prior to reform. Many market participants may prefer the devil that they know. Others may be concerned about distributional effects of even efficient improvements in LIBOR. If an improved LIBOR skews higher as a result, it will disadvantage the payor on a LIBOR instrument. Finally, substantial changes to the rate could result in legal challenges to the validity of linked instruments.

(2) *Transparency versus opacity*: It is easy to be upset about the lack of transparency in LIBOR, which allows bad behavior to go unnoticed or unverified. However, opacity has its virtues since reputational manipulation of LIBOR was a direct result of banks' fears that true but embarrassing submissions would be revealed to the public. Likewise, rules and data make it easier for third parties to game the system by engaging in transactions pitched to the rules.

(3) *Public accountability versus optimal incentives*: Government ownership of an index, stipulation of rules, or harsh punishment for index wrongdoers may increase a sense of public oversight. However, the government may lack incentive and the knowledge to craft an index correctly, and harsh rules and penalties may drive participants away from contributing to the index.

An improvement to one aspect of the indexing processes necessarily increases risks in another. The rest of this subpart examines the reforms recommended by the Wheatley Review, the reforms implemented by settlements with three banks, and reforms suggested but not yet implemented. For each, understanding the trade-offs involved in regulatory change helps sensitize us to the costs of any particular proposal.

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122. Rauterberg & Verstein, *supra* note 40.

1. *Fewer LIBORs*

The Wheatley Review proposes that LIBOR will be quoted in fewer tenors and currencies. As it stands, LIBOR is quoted in ten currencies and at fifteen different borrowing durations. Some of these are based on markets with substantial volume, such as the overnight USD rate. Some are extensively used by third parties, such as the three-month USD rate, which is among the most important for U.S. subprime mortgage pricing.[123] Yet, some are little used by third parties,[124] and based on very few underlying transactions, such as the eleven-month Swedish Krona.[125] Recognizing the potential to manipulate such a thinly-traded market, Wheatley recommends eliminating 130 of the 150 LIBOR rates.[126]

The BBA considered eliminating tenors as well, but declined to do so. While the Wheatley review asserts that the cost of eliminating lesser tenors is low, the BBA considered them significant. As John Ewan said, "Should we stop doing these? Somewhere, someone is doing a product that links to the unlikely rate."[127] Without knowing who was using the unlikely rate and why they deemed it better than a market favorite, the BBA was unwilling to act. The BBA recently published a consultative report surveying various market participants as to their feelings on eliminating such little-used tenors. This report confirmed Wheatley's sense that many LIBORs were not favorites of the market, but also confirmed Ewan's sense that there remain devoted users of these benchmarks who will be the losers in any elimination plan.[128] For example, a majority of respondents agreed that the BBA could eliminate its little used tenors, as well as the Australian Dollar, New Zealand Dollar, Canadian Dollar, Danish Krone, and Swedish Krona fixing. Nevertheless, for each of these, between nine percent and twenty-nine percent of the respondents *opposed* discontinuing the rate. There appears to be a significant group of users that finds these rates to be at least sometimes useful.[129]

Here, as with elsewhere, the BBA appears to have taken grandfathering concerns seriously. Again, recent market surveys substantiate the BBA's caution. More than half of the market participants surveyed expressed

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123. Fifty-nine percent of USD-denominated swaps and floating rate notes that cite LIBOR utilize the three-month tenor. *See, e.g.*, THE WHEATLEY REVIEW, *supra* note 44, at 36 tbl. 5.A.

124. Essentially zero percent of interest rate swaps and floating rate notes quote the one-, three-, six-, or twelve-month Swedish Krona. *Id.*

125. Less than seven of the LIBOR banks engaged in Swedish Krona borrowing in any substantial quantity, and none did so at the eleven-month maturity. *Id.* at 30 tbl. 4.A.

126. *Id.* ¶¶ 5.9–5.10.

127. Interview with John Ewan, *supra* note 102.

128. BRITISH BANKERS' ASS'N, STRENGTHENING LIBOR — PROPOSAL TO IMPLEMENT RECOMMENDATION NUMBER 6 OF THE WHEATLEY REVIEW OF LIBOR — SUMMARY OF FEEDBACK RECEIVED (2013), *available at* http://www.bbalibor.com/download/8739.

129. *Id.* at 3–5.

concern about rapid removal of lightly-traded tenors, and substantial minorities expressed concern about removal of such tenors and currencies even within the longer time horizon suggested by Wheatley.[130]

Wheatley's response acknowledged that eliminating tenors would decrease cross-tenor corroboration.[131] Likewise, there was reported concern "about the impact on those contracts that reference these rates and the associated market disruption, suggesting a cautious approach in this respect and that, in each case, an appropriate consultation with the relevant domestic authorities should be undertaken to ensure minimal disruption."[132]

2. *Quote Anonymity*

Wheatley also proposes that LIBOR-rate contributions be unavailable to the public for three months. The thought is that this will allow contributor banks to more honestly represent their cost of borrowing, since they need not fear that high costs will be immediately reported to the market and interpreted as a sign of weakness.[133] It may also make it more difficult for a cartel to enforce an agreement to manipulate the rate, since a breach of the agreement would remain invisible for some time.[134] Additionally, would-be manipulators could not so easily predict the effect of their quote upon the overall field,[135] since they could not observe how close the rate was to being rounded up or down.[136]

Once again, looking at the BBA provides insight into the trade-offs of this regulation. The BBA considered such a proposal and declined after consultation with its constituents. Sixty-one percent of respondents told the BBA that the existing level of anonymity was best, and only fifteen percent wished an increase in opacity of rates.[137] Wheatley's compromise between transparency and opacity, a period of delay before data are released, was endorsed by exactly two of the BBA respondents.[138] Market

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130. *Id.*

131. THE WHEATLEY REVIEW, *supra* note 44, app. ¶ B.13.

132. *Id.* app. ¶ B.12.

133. *Id.* ¶ 5.15 ("Real-time publication of submissions can create incentives to submit a lower rate than would otherwise have been submitted.").

134. *See, e.g.*, BAINBRIDGE, *supra* note 115, at 32. This hardly seems significant since cartel members could voluntarily show their participation through any number of means.

135. *See, e.g.*, THE WHEATLEY REVIEW, *supra* note 44, ¶ 5.15.

136. However, given the ease with which contributors, traders, and voice brokers communicated, it would seem that this reform will have little effect unless other dynamics are substantially changed.

137. BRITISH BANKERS' ASS'N, BBA LIBOR CONSULTATION, *supra* note 47, ¶ 1.14 ("Many respondents, and particularly those of the contributing banks, considered that a decrease in the current level of transparency would not necessarily be interpreted as positive move."). This is consistent with the information gathered by the Wheatley Review. THE WHEATLEY REVIEW, *supra* note 44.

138. *See, e.g.*, BRITISH BANKERS' ASS'N, BBA LIBOR CONSULTATION, *supra* note 47, § 3.18.

participants were concerned that a lack of transparency on submissions could further cast a shadow over the rate, as participants could not readily compare submission data to comparable metrics. Many of the important studies identifying LIBOR manipulation relied on bank-level data to determine where banks' self-evaluation of creditworthiness did not match the market.

B. *The Settlements*

Not only are new regulations emerging from explicit, legislative reforms in the United States and United Kingdom, but enforcement and action through the judicial system are making an equally important impact. The recent internationally-coordinated settlements between state regulators and LIBOR panel banks illustrate how settlements can function as regulation. Furthermore, they underscore the interaction of domestic governmental regulators (operating through both enforcement and legislation) and transnational private regulators in regulating aspects of the OTC derivatives market.

In June 2012, Barclays PLC settled Commodity Exchange Act violations with the CFTC. Barclays' settlement involved numerous non-financial terms. It agreed to substantive provisions for how it will contribute to benchmark rates. Within six months of the Barclays order in December 2012, UBS similarly settled claims with the CFTC and Britain's market conduct regulator on essentially the same terms.[139]

The settlement provides directives for how Barclays must calculate its LIBOR quote submissions. Barclays must give its own transactions the greatest weight in determining submissions,[140] though it may modify that data with subjective assessments of market and counterparty conditions.[141] The settlement also extensively specifies the oversight and governance structures within the firm.[142] Firewalls, both bureaucratic and geographic,

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139. UBS AG & UBS Sec. Japan Co., Comm. Fut. L. Rep. (CCH) ¶ 32,481 (Dec. 19, 2012), *available at* http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfubsorder121912.pdf (order instituting proceedings pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act making findings and imposing remedial sanctions).

140. Barclays PLC, No. 12-25, at 32 (C.F.T.C. June 27, 2012), *available at* http://cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfbarclaysorder062712.pdf (noting that submissions may include overnight index swaps, currency futures, repos, futures, Fed Funds and other factors).

141. *Id.* at 33 (noting that other factors may include time, market events, term structure, credit standards, counterparty conditions and baselines).

142. *Id.* at 34 (requiring the daily submissions to be reviewed every day by a supervisor experienced in the market and prohibiting supervisors and submitters from having compensation linked to derivatives trading or being derivatives traders); *id.* at 39 (requiring compliance personnel to physically visit trading floors at least monthly).

are to be established.[143] Extensive records are to be kept[144] — even of factors that are notoriously intangible[145] — and the data must be coded along eighteen axes.[146] Regular disclosures to regulators are required,[147] as are audits.[148] The settlement even includes public advocacy requirements.[149]

It is fair to say that these settlement-imposed changes to the rate-setting process are far more extensive than those proposed by the Wheatley Review. Settlements for past wrongdoing entail an avenue for substantial public oversight and substantive prescription of business conduct. This is regulation by settlement, and it comes as a replacement to a governance regime that was deemed to be inadequate, but which contemplated many of these prescriptions.

The BBA declined to provide extensive *ex ante* guidance as to how banks must produce their submissions and to put "twenty minions at each bank to make sure they are flying straight."[150] They deemed themselves comparatively less well-equipped than banks to tell each bank how best to craft its own compliance and risk management,[151] and to draft extensive rules that would apply in various and future cases. Instead, the BBA required banks to have their own compliance and auditing services certify their submissions. The BBA also deemed it appropriate to offer only minimal guidance, such as that the cash dealer and not the swap trader must submit the quotes. Likewise, the BBA played a role in clarifying the

143. *Id.* at 34–35.

144. *Id.* at 37 (requiring that essentially all communication about the index be preserved, with preservation time depending on the media format and location of the individuals); *id.* at 37 (requiring trades and positions, and those of other traders dealing with these markets, to be recorded and kept); *id.* at 36 (requiring supervisor identity be recorded and kept for five years); *id.* at 35 (requiring the preservation of all models and methods included in submissions); *id.* at 35 (requiring the preservation of all voice broker offers and information, including identification (company, person, etc.) of specific offers upon which submission is based).

145. *Id.* at 35–36 (requiring the preservation of the definition of "reasonable market size" used in the submission); *id.* at 36 (requiring that submissions note which specify market announcements or effects entered into their assessment and what effects those events were deemed to have had); *id.* at 35 (requiring Barclays to keep a record of each submission for five years, including the factors that influenced the submission and their relative weight, and a list of the transactions deemed non-representative and therefore not included).

146. *Id.* at 36 (requiring transactional data to note, *inter alia*, customer number, interest basis (360/365-day year) and maturity date).

147. *Id.* at 40 (requiring Barclays to make an interim report to the CFTC about its progress every four months); *id.* at 41 (requiring the immediate report of any attempted manipulation or improper conduct to the CFTC); *id.* at 35 (requiring that all of these records be available to the CFTC at any time, without subpoena).

148. *Id.* at 38 (requiring an internal audit every six months, including random sample of submissions and evidence); *id.* at 35 (requiring a third-party audit annually).

149. *Id.* at 42 (requiring Barclays to advocate for the index provider to signal whether rates are based on actual transactions).

150. Interview with John Ewan, *supra* note 102.

151. *Id.*

rules whenever changing circumstances made clarification useful, such as whether a government-supported loan's cost should count when a bank calculated its cost of funds. Ongoing, particularized advice was considered to be more fruitful than extensive upfront rules.

This evaluation was not just based on institutional competence. The BBA's consultation with its constituents led it to think that greater *ex ante* specificity in processes was not to be desired. For example, the settlements provide extensive guidance on the content of the submission, requiring the submitting bank to define "reasonable" market size clearly. By contrast, the BBA's report found that seventy-seven percent of the thirty-one formal responses opposed requiring a fixed and clear account of market size, while only one thought that formalizing the question would be helpful.[152] The Wheatley Review came to the same conclusion, declining to stipulate what question LIBOR is set to answer, or how precisely firms must do so.[153] While the settlements are intended to improve LIBOR, they require policies that were rejected by the Wheatley Review and the BBA. A measured approach is therefore appropriate, especially when the method of applying these requirements is an *ad hoc* process of unilateral settlements.[154]

C. Other Reform Proposals

Transaction-Based Index. Many experts have argued that LIBOR should be replaced by an index that is based only on genuine transaction data, which would be public or publishable if necessary. The Wheatley Review declined to make this recommendation in part because most market participants responding to Wheatley said this was not feasible.[155] The BBA came to the same conclusion.[156]

Eliminate LIBOR. Professor Michael Barr, former Assistant Secretary of the Treasury for Financial Institutions, has said that LIBOR is unnecessary in good markets and untrustworthy in bad markets.[157] He has urged regulators to push for the transition to a new index. Yet, the Wheatley

152. *See, e.g.*, BRITISH BANKERS' ASS'N, BBA LIBOR CONSULTATION, *supra* note 47.

153. *See, e.g.*, THE WHEATLEY REVIEW, *supra* note 44, ¶ 2.14.

154. *See generally* Rebecca Tabb & Joseph Grundfest, *Alternatives to Libor* (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 138, 2013), *available at* http://ssrn.com/abstract=2272462.

155. *See, e.g.*, THE WHEATLEY REVIEW, *supra* note 44, app. ¶ B.19. Those few participants who supported it did so with designs for a regulatory subsidy addressing the dearth of transactions. *Id.* app. ¶ B.20 ("for example, by creating special considerations for the inter-bank market, similar to market-maker exemptions (e.g. capital relief, more relaxed liquidity rules, etc.)").

156. *See, e.g.*, BRITISH BANKERS' ASS'N, BBA LIBOR CONSULTATION, *supra* note 47, at 4 (stating that an element of judgment will always be required).

157. *See, e.g.*, Michael Barr, *It's Time to Take the 'E' Out of "LIE-BOR,"* YAHOO! FIN. (Oct. 17, 2012, 7:46 PM), http://finance.yahoo.com/blogs/the-exchange/barr-time-e-lie-bor-234646443.html#more-id.

Review concluded that transition to a new index "would pose an unacceptably high risk of significant financial instability, and risk large-scale litigation . . . ."[158] Similar concerns have been expressed by Ben Bernanke[159] and industry representatives.[160]

Any change to LIBOR's fundamental operations could create uncertainty and litigation costs, as some parties may seek to invadidate their contracts. These risks are especially high if the new LIBOR generally disadvantages some constituency. While appropriate chain and transition rules could prevent an abrupt change in the rate, a clumsy transition to a new methodology would result in systematically higher or lower rates, with greater or lesser volatility.[161] With so many contracts linked to LIBOR — subprime mortgages in Alabama, bond issues by the city of Baltimore, Eurodollar futures contracts traded in Chicago, syndicated loans for infrastructure projects in Pakistan, and interest rate swaps between multinational conglomerates — it is impossible to predict how a new LIBOR could affect all of its users.

Abrupt or not, some participants want relatively little change to LIBOR. They like it for its correlation to bank borrowing costs, and prefer it to other rates.[162] Market participants have not voted with their feet, even though there are other rates available. Despite all of the negative publicity, there is no indication of a decline in LIBOR use.[163]

Government-run LIBOR. Some experts have urged government provision of the LIBOR benchmark or its replacement index.[164] It is thought that "a

158. THE WHEATLEY REVIEW, *supra* note 44, ¶ 1.12. *See also id.* app. ¶ B.34 ("Most responses recommended caution with regards to making significant changes to LIBOR, in case it puts existing transactions at risk . . . . There was also a concern that step changes in the rate as a consequence of changes to LIBOR may pose legal difficulties.").

159. *See, e.g.*, Shahien Nasiripour, *US Regulator Calls for Faster Libor Reform*, FIN. TIMES (Sept. 24, 2012, 7:33 PM), http://www.ft.com/intl/cms/s/0/e617878a-065b-11e2-abdb-00144feabdc0.html#axzz2bOmmDR00 ("'The problem is that, of course, we have enormous amounts of existing contracts, not just derivatives contracts, but a variety of other kinds of loans and securities which are based on [LIBOR],' Mr. Bernanke said. 'And until those are negotiated away or they expire, we have this huge legacy issue of [LIBOR]-based financial contracts.'").

160. *See, e.g.*, Brook Masters, *Fast Libor Reform 'Risks Causing Chaos*,*'* FIN. TIMES, (Sept. 10, 2012, 7:37 PM), http://www.ft.com/intl/cms/s/0/b805fa0a-fb40-11e1-a983-00144feabdc0.html#axzz2U2WSsWYw (citing corporate borrower group and investment management associations' concerns).

161. *See* Sarah Lewis, *150 Shades of Libor,* FOCUS (Nov. 26, 2012), http://www.trinityllp.com/150-shades-of-libor/ (arguing that reformed LIBOR could lead to higher, more volatile, rates).

162. *See, e.g.*, Rosa M. Abrantes-Metz & David S. Evans, *Will the Wheatley Recommendations Fix LIBOR?*, CPI ANTITRUST CHRONICLE, Nov. 2012, at 3 (noting that "market participants . . . presumably have believed that LIBOR was conceptually the best rate to rely on and that it was superior to other readily available benchmarks"); *see also* BAINBRIDGE, *supra* note 115, at 40–41 (noting problems with other indices); Rauterberg & Verstein, *supra* note 40, at 49.

163. *See, e.g.*, The WHEATLEY REVIEW, *supra* note 44, ¶ 1.13.

164. *Id.* app. ¶ B.31. Some of the responses to the Wheatley Review's initial discussion paper argued "that the authorities should take ownership of the rate, including rate-setting . . . ." *Id.*

government benchmark would not be vulnerable to the sort of manipulation to which LIBOR has been subjected."[165] Yet government manipulation of indices is also possible.[166] Indeed, some of the LIBOR manipulation that occurred is alleged to have been at the behest of government officials concerned about policy objectives.[167] The basis risk would be higher for a government-run index unless it was based on the same borrowing rates of the current LIBOR,[168] in which case it would face the same problems of insufficient data in thin markets as does LIBOR. In any case, parties already have the option to use a government rate if they wish, so it seems unlikely that eliminating a prominent non-governmental option would assist parties. At the same time, the Wheatley Review worries that a publicly-run LIBOR would not adapt to user needs as quickly as does a privately-provided benchmark.[169] Wheatley therefore recommended against government control of the index.[170]

D. *Regulatory Pathologies*

Closer scrutiny of the record of LIBOR and the BBA during its period of putative "deregulation" provides other important lessons for future reform. One lesson involves the ways in which public regulators can be captured or otherwise rendered powerless. Unsettling evidence has suggested that regulators may have known, tacitly approved, or even recommended manipulation of LIBOR to panel banks.

Some amount of LIBOR manipulation may have been with the blessing of state regulators. Bob Diamond testified that senior British officials had raised concerns that Barclays' rates were too high and that it would be better to lower them.[171] In other correspondence, it was suggested that Paul Tucker, Deputy Governor of the Bank of England, may have been among the regulators blessing the depressed rate. Diamond carried the message to his subordinates. Jerry Del Missier gave the instruction, believing that he was following indirect orders from the Bank of England. As *The Economist* put it, there is "evidence that can be interpreted as an implicit nod from the Bank of England (and Whitehall mandarins)" to engage in manipulation "to bolster confidence in banks and keep credit

165. BAINBRIDGE, *supra* note 115, at 39.
166. *See, e.g.*, Rauterberg & Verstein, *supra* note 40, at 135–40.
167. *See* discussion *infra* Part II.D.
168. *See, e.g.*, BAINBRIDGE, *supra* note 115, at 38.
169. *See, e.g.*, THE WHEATLEY REVIEW, *supra* note 44, ¶ 3.7.
170. *Id.* ¶ 1.16.
171. *See, e.g.*, James Chapman & Becky Barrow, *Revenge of a Fallen Titan: Ousted Barclays Boss Makes Damning Claims Bank of England and Labour Ministers Were Involved in Rigging Interest Rates*, DAILY MAIL ONLINE (last updated July 4, 2012, 6:59 AM), http://www.dailymail.co.uk/news/article-2168449/Bob-Diamond-resignation-Ousted-Barclays-boss-makes-damning-claims-Bank-England-Labour-ministers-involved-rigging-rates.html.

flowing."[172] The manipulating banks thus may have had "tacit permission from their regulators."[173] The impulse behind potential regulatory cooperation in rate manipulation might be understandable as the health of domestic financial institutions during the financial crisis became intertwined with the survival of the real economy.

The Federal Reserve Bank of New York was informed — perhaps in April 2008,[174] perhaps in August of 2007[175] — that Barclays was underestimating its rates. This resulted in a June 2008 email to Merwyn King, Governor of the Bank of England, from U.S. Secretary of the Treasury Tim Geithner. The ten-point recommendations included in the email were essentially copied from the BBA's own proposal, meaning that the government's only regulatory response was to adopt a regulation from industry. Those proposals ended up being forwarded back to the BBA.[176] That proposal went nowhere, with U.K. officials denying that they had even received such notice.[177]

These disturbing possibilities of regulatory involvement in the provision of inaccurate borrowing quotes for LIBOR suggest that in order to be effective, future public regulation of LIBOR may need to be cordoned off from political interests. This underscores the importance of recognizing the risks of public index provision.[178] Viewing the BBA as a regulator also allows one to see it as a captured regulator, entirely too tolerant of the banks it supervised. This, again, reminds us of the importance and difficulty of protecting public regulators from industry capture.

Regulators of all stripes make mistakes, and our attention must be focused on how to help them make better decisions. Jon Macey opined that "regulators foolishly looked to [LIBOR] to determine the market's perception of the health of big banks."[179] Will they make the same mistake

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172. *How Britain's Rate-Fixing Scandal Might Spread — And What to Do About It*, ECONOMIST (July 7, 2012), *available at* http://www.economist.com/node/21558260.

173. *Id.*

174. *Libor Talks Go Back to Early '08*, WALL ST. J. (last updated July 14, 2012, 3:06 AM), http://online.wsj.com/article/SB10001424052702303919504577524510853665528.html.

175. *See, e.g.*, Rachelle Younglai & Pedro da Costa, *Geithner Says Did All He Could to Address Libor Problem*, CHI. TRIB. (July 26, 2012), http://articles.chicagotribune.com/2012-07-26/news/sns-rt-us-usa-geithnerbre86o0vc-20120725_1_libor-responsibility-for-market-manipulation-british-bankers-association.

176. Forwarded e-mail from Mervyn King to Timothy Geithner (June 3, 2008, 9:21 AM), *available at* http://www.newyorkfed.org/newsevents/news/markets/2012/libor/June_3_2008_email_from_Mervyn_King.pdf.

177. *See, e.g.*, Mark Scott, *Bank of England Chief Denies New York Fed Gave Warning on Rate-Rigging*, N.Y. TIMES DEALBOOK (last updated July 17, 2012, 8:05 AM), http://dealbook.nytimes.com/2012/07/17/bank-of-england-chief-denies-n-y-fed-gave-warning-on-rate-rigging/?scp=2&sq=bank%20of%20england&st=Search.

178. *See* Rauterberg & Verstein, *supra* note 40.

179. Jonathan Macey, *Libor: Three Scandals in One*, FOREIGN AFFAIRS (July 20, 2012), *available at*

if given greater control over this space? Will more frequent meetings and more formalistic procedures increase unjustified confidence? Abrantes-Metz and Sokol argue that the LIBOR manipulation was easy to detect: "Had any member bank that set [LIBOR] or any antitrust authority undertaken an econometric screen, they likely would have detected these anomalies . . . ."[180] What causes regulators to decline to use these screens, just as the BBA and its members did, if they can be so effective?

E. *The Limits of Private Regulation*

Private regulation failed in the OTC space because of steps private regulators chose not to take. However, among those omissions were actions that the private regulators *could not* have effectuated. While a private regulator can create advantageous circumstances for those who conform to best practices or standardized ways of doing business, such a regulator may have difficulty preventing free-riders from taking advantage of the system to which others contribute. For instance, a transnational private regulator will have little ability to create and enforce intellectual property regimes.

For example, the LIBOR banks incur significant costs to contribute to the rate. Other banks and entities enjoy the use of a widely-known rate, but they may not end up paying for it. A private regulator has only limited powers of exclusion over information. ISDA, for example, provides that its agreements are valid only when printed on paper purchased from ISDA. Whether this self-destruction language actually proves effective, ISDA has found a cumbersome way at least to imply that unauthorized users do not enjoy full benefits.

The BBA can delay access to LIBOR data, but cannot effectively exclude non-paying users given the state of intellectual property in many nations. Without the ability to internalize much of its users' gains, incentives are skewed for actors subject primarily to transnational private regulators.[181] Sometimes the solution may be to allow the transnational private regulators some limited power over the provision of intellectual property. More often, state actors must focus on those regulatory powers that they are unwilling to delegate to the private regulator.

Further, the LIBOR incident may be "too big to litigate," because even the panel banks — many of the world's largest and most important financial institutions — may not have pockets deep enough to actually

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http://www.foreignaffairs.com/articles/137789/jonathan-macey/libor-three-scandals-in-one.

180. Rosa M. Abrantes-Metz & D. Daniel Sokol, *The Lessons from Libor for Detection and Deterrence of Cartel Wrongdoings*, 3 HARV. BUS. L. REV. ONLINE 11 (2012), http://www.hblr.org/2012/10/the-lessons-from-libor-for-detection-and-deterrence-of-cartel-wrongdoing/.

181. *See* Rauterberg & Verstein, *supra* note 40.

compensate victims for the sums of money that inappropriately changed hands if misleading submissions dramatically altered the LIBOR rates. The structure of "too big to litigate" exists within the OTC derivatives market, at least in part because the central private regulators — ISDA and the BBA — produce valuable intellectual property that structures market transactions (through documentation and reference rates, respectively) as something like public goods. As a result, neither of these organizations, nor the major commercial entities that inform their output, fully internalize anything like the profit stream that their intellectual property could make available. A difficulty results: the production of intellectual property as a public service means that there may not be sufficient funds available to hold culprits accountable if misuse occurs.[182]

Besides the odd problem of the world's biggest banks potentially being judgment-proof because LIBOR was largely provided for free, this combination of private regulatory production of public goods has its own particular hazards.

All of the products offered by ISDA — its ubiquitous documentation, legislative efforts, or Credit Derivatives Committees — are produced through a particular kind of information production, which we have called byproduction elsewhere.[183] Information is byproduced when it is produced as an incident to some other profit-generating activity.[184] For instance, the New York Mercantile Exchange creates the NYMEX financial index and the financial participants on ISDA's influential committees draft ISDA's documentation, but neither corporate entity's principal motivation is the production of that information.[185] Rather, derivatives markets participants

182. These structural features of ISDA documentation and LIBOR are discussed in far greater detail elsewhere. *See* Rauterberg & Verstein, *supra* note 40. Stephen Bainbridge has addressed the analysis of intellectual property and incentives therein with some subtlety, but also with several errors. *See* BAINBRIDGE, *supra* note 115, at 45–50. For instance, Bainbridge misses that producers of financial intellectual property will need property protection from wherever their fees principally accrue. Bainbridge also fails to recognize that the value of the intellectual property of LIBOR and ISDA documentation could quickly grow stale and useless in the absence of adequate incentives. Unlike a static piece of intellectual property, such as a book or patent, most financial intellectual property is iteratively produced and dynamic, and outdated information can be worse than useless. That intellectual property reform should be supplemented by other reforms — in the LIBOR context or elsewhere — is something that we never deny.

183. *See, e.g.*, Rauterberg & Verstein, *supra* note 40, at 135–40.

184. *See* Bruce H. Kobayashi & Larry E. Ribstein, *Law as a ByProduct: Theories of Private Law Production* (Ill. Law, Behavior & Soc. Sci. Research, Research Paper No. LBSS11-27, 2011), *available at* http://ssrn.com/abstract=1884985 (distinguishing production and byproduction); Bruce H. Kobayashi & Larry E. Ribstein, *Private Lawdrafting, Intellectual Property, and Public Laws* (George Mason Univ. Law & Econ. Research Paper Series, Paper No. 13-20, 2013), *available at* http://ssrn.com/abstract=1986455.

185. *See, e.g.*, N.Y. Mercantile Exch., Inc. v. Intercontinental Exch., Inc., 497 F.3d 109, 118 (2d Cir. 2007) (discussing incidental production of information by NYMEX).

serve on ISDA's committees in order to assist in creating the financial infrastructure that enables efficient transacting.

Byproduction has two features that promote the likelihood of byproducts serving as public goods. The first is conceptual: a byproduct is not designed by its creators as a principal profit-making instrument. The second is its corollary: because a byproduct is an incident to some other-directed commercial activity, it is typically low-cost to its producers. For both of these reasons, byproducts will often be provided to third parties as a public good.

Related to these benefits, however, are several structural features of byproduction that make it especially prone to certain regulatory failures. Byproducts often employ private internal firm data (hence, their status as byproducts), making misuse or manipulation of that data more difficult to detect. Byproducts are, by definition, not a primary firm income generator, and sometimes will not be significant income producers at all. If so, then the incentive to maintain the byproduct's quality and reputation — an incentive that can dilute manipulative impulses — will be absent. Finally, and most importantly, like any form of joint production,[186] byproducts are generated alongside some other product, and creators may have a conflict of interest if the byproduct can impact the primary product's success.

Byproduction of harmonized regulation can often be an efficient way for markets to be governed, and private regulators can often produce it efficiently. However, this mode suffers from structural limitations, both in terms of incentives and powers. While awareness of private regulation can often relieve the state of regulatory burdens, the state's interventions may be doubly important where private regulation is unlikely to work well.

F. *Assessing the Desirability of Regulatory Abdication*

LIBOR manipulation may have created an inefficient distribution of wealth during the period of improper quote provision.[187] Beyond simply wreaking havoc in the absence of regulation, an unregulated LIBOR may have also frustrated government regulation intended to improve the economy in the early days of the Great Recession. In December 2007, the Bank of England cut the base rate fifty basis points to 5.5%. LIBOR fell by only four basis points. As the senior technical manager of one of England's largest mortgage brokers put it, "The rate cut has not had the usual reaction in the market."[188] One possible explanation for the unresponsiveness could be that monetary policy efforts — intended to

186. *See generally* M. Ishaq Nadiri, *Joint Production*, *in* 2 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 1028 (John Eatwell et al. eds., 1987).

187. *See* BAINBRIDGE, *supra* note 115, at 9.

188. Tanya Powley, *Libor Stays High Despite Rate Cut*, MONEY MKTG., Dec. 13, 2007, at 5.

lower rates to borrowers, improve liquidity, and stimulate the economy — were undermined by false submissions.

Yet, willful unresponsiveness to policy levers implies that the BBA or LIBOR banks had the power to use LIBOR to affect monetary policy by contributing to perceptions of the direction of short-term interest rates, the target of the Bank of England's policy move. This is consistent with the prior discussion that the state may have delegated some amount of control over interest rates to the BBA.[189] It may be that LIBOR, in taking on a monetary policy function from the state, has done more than allow for interest rate protection.

Consider one problem during the financial crisis and how LIBOR might have been involved: the inability to reduce principal or interest payments to mortgage borrowers. Many borrowers owned homes that were "under water," and hence worth less than their indebtedness. For such borrowers, it could be rational to default on the loan. For others, the home equity exceeded liability, but they found monthly payments to be untenable. This may have been due to illness or unemployment. Alternatively, they may have been in the practice of obtaining loans with a teaser rate and then refinancing, but when such refinancing had become unavailable, their monthly payments increased to an unaffordable level.

Many experts have argued that borrower and lender alike would benefit from a modification under these circumstances, but modifications were surprisingly rare. Explanations for this scarcity are many. Securitization of loans meant that the initial lender, the loan servicer, and the entity entitled to payment from the borrower were unlikely to be the same entity, raising the complexity of modification. The loan servicers, those best positioned to effect modifications, may have been afraid of liability to owners of the loan for modifications adverse to their interests. It would have been difficult and costly to obtain broad agreement amongst the owners of various tranches of mortgage-backed securities (MBS), whose interests were often adverse. Even where agreement or waiver could be cheaply obtained, loan servicers sometimes had little incentive to propose a workout since they also received payments for their work in addressing defaulted mortgages. Likewise, it would be difficult for a consortium of owners of the reference loan to actively monitor its servicer, allowing the agent a great deal of discretion. Those coordination problems concern the intra-security conflicts attendant to a single mortgage-backed security, but the entire pool of mortgage-backed security owners may have had their own coordination problem. With each defaulted mortgage, home values nearby plummet and other mortgage-backed securities are endangered. MBS investors, as a class, might have benefited if each had taken steps to

189. *See supra* text accompanying notes 108–09.

modify loans in consideration of the benefit to other MBS investors. But absent some mutual commitment, few investors would take account of this positive externality.

Finally, many owners of mortgage-backed securities would dislike a modification or writedown even if it resulted in fewer costly defaults. Such modifications could designate the security as delinquent in payment, and thus subject to credit downgrading. For regulated entities, such credit downgrades can have severe impacts, such as triggering a need to raise additional capital at a time when capital may not be forthcoming. Such entities would prefer a "non-modification modification," which is precisely what LIBOR might have allowed.

LIBOR manipulation may have helped solve all of these problems.[190] Under one possible account of LIBOR manipulation, the contributor banks lowered their submissions in order to protect their reputations. If this were true, it would have had the effect of lowering the LIBOR rate. This in turn would have lowered the monthly payments and interest obligations of all borrowers linked to LIBOR, which would have included the vast majority of subprime borrowers, those most at risk of default. Thus, successful downward manipulation of LIBOR could have arguably achieved an efficient result from one perspective — overcoming transactions costs and agency problems, as well as easing the stress on borrowers precisely when they needed relief.

To be sure, not every account of the macro-effect of downward LIBOR manipulation is so glowing. Bainbridge points out that low LIBOR rates would fail to compensate lenders for the risks they assumed in lending and would cause losses to many mutual funds and hedge funds.[191] This is surely right, at least unless and until margins on the rate adjusted to the new norm. But wondering whether this type of transfer helped or harmed the crisis in the long-term is precisely the kind of question we would ask if the Federal Reserve or a regulator had engaged in similar easing or cramdowns.

These considerations are part of a broader normative question as to whether political institutions should sometimes pressure financial entities to engage in behavior that is inefficient or misleading, if it is perceived to have some critical consequence for the economy. The "too big to fail" debate may have an intriguing and analogous phenomenon in the world of financial infrastructure: LIBOR may be "too big to end" and "too big to regulate" simply because its essential importance as a sign of health for a

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190. *See, e.g.*, BAINBRIDGE, *supra* note 115, at 9 (stating that "the misreporting of the LIBOR data may actually have made the banking crisis worse in the long term"). *See also* Rosa M. Abrantes-Metz et al., *Tracking the Libor Rate*, 18 APPLIED ECON. LETTERS 893, 897–99 (2011); Rauterberg & Verstein, *supra* note 40, at 104 (discussing harms of LIBOR manipulation).

191. *See, e.g.*, BAINBRIDGE, *supra* note 115, at 9.

nation's banks compromises the capacity of public regulators to govern it objectively and demand accuracy at all times.

G. *Market Spaces Without Public or Private Regulation*

In light of private regulation, the OTC derivatives market cannot be accurately described as unregulated. Indeed, even in terms of state regulation, the market has long been subject to important forms of oversight and accountability at the entity level. In fact, the vast majority of swaps dealers are regulated at the entity level as either banks or financial firms.[192]

There are financial markets that come close to being genuinely unregulated — subject to no robust rules of conduct in certain respects — and they look very different from the OTC derivatives markets. Appreciating the real, if limited, role of private regulation highlights the unique character of those markets that have no public, private, or mixed regulation. One interesting example is insider trading in the commodities markets. In the commodities markets, insider trading is, for most purposes, legal. "In contrast to the broad prohibition against insider trading found in the securities laws, insider trading is considered an accepted and integral practice in the commodity futures and derivatives markets."[193] While there are perfunctory gestures at adopting different private norms,[194] the commodities markets simply do not have a domestic or transnational

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192. *See* Jerry W. Markham, *"Confederate Bonds," "General Custer," and the Regulation of Derivative Financial Instruments*, 25 SETON HALL L. REV. 1 (1994) (indicating, at that time, more than ninety percent of the top fifty entities dealing in interest rate swaps were banks, financial firms, or affiliates already subject to regulation); *Testimony Before the Subcomm. on Sec., Ins. and Inv. of the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 11 (July 9, 2008) (statement of Katherine E. Dick, Deputy Comptroller for Credit & Market Risk, Office of the Comptroller of the Currency), *available at* http://www.occ.treas.gov/ftp/release/2008-79a.pdf (noting that "the vast majority of significant participants in these markets are regulated"). Additionally, OTC swap transactions remained subject to antifraud provisions. *See, e.g.*, EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 14.05 (10th ed. 2013); *see also Governance*, *supra* note 104 ("As all contributor banks are regulated, they are responsible to their regulators, rather than BBA LIBOR Ltd. or the LPBAUG, for maintaining appropriate procedures for contributing.").

193. Bradley J. Bondi & Steven D. Lofchie, *The Law of Insider Trading: Legal Theories, Common Defenses, and Best Practices for Ensuring Compliance*, 8 N.Y.U. J.L. & BUS. 151, 167 (2011) ("Not only does the Commodity Exchange Act (the 'CEA') lack a prohibition against insider trading in commodities (except with respect to certain individuals connected with the regulation, self-regulation, or exchange governance of those markets), but the CEA actually accepts insider trading as a means to facilitate efficient pricing of commodities."). Front running certainly is illegal, but importantly, it does not encompass anything like the full range of activities prohibited by insider trading laws in the equities markets.

194. *See, e.g.*, INT'L ORG. OF SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION (June 2010), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf. The International Organization of Securities Commissions' (IOSCO) Core Principles prohibits insider trading.

private body that effectively enforces an additional set of rules. This unregulated aspect of the commodities markets highlights their basic economic functions:

> [T]he purpose of the commodity futures and derivatives markets is to provide a forum for price discovery and risk management . . . [and] as a joint report by the SEC and CFTC acknowledges, 'permit hedgers to use their non-public material information to protect themselves against risks to their commodity positions.' . . . 'it would defeat the market's basic economic function — the hedging of risk — to question whether trading on knowledge of one's own position were permissible.'[195]

Different trading markets can serve dramatically different functions and be served by different rules. While domestic equity markets with broad societal participation may benefit from a regulatory prohibition against the use of insider information, other markets, like the commodity futures markets, exist in part to enable insiders to express their knowledge in trading strategies.[196] Recognizing the significant differences between a market without governmental regulation and one bereft of any regulation whatsoever may well have a valuable lesson to teach as to the function of the unregulated activity for that market.

H. The Domesticity of Transnational Private Regulators

Transnational private regulation can only outrun the state so far. Ultimately, even a transnational private regulator must be subject to at least one (and potentially many) public regulatory regimes. This "home" or domiciliary of the private regulator will often have its status solely as the result of historical contingency, rather than as the result of conscious choice by the regulated, third parties, or coordination by international governments. Nonetheless, the law of this home state will have a tremendously outsized power over what is now a truly transnational regulatory regime. LIBOR provides a compelling example of this concept. The Wheatley Review may be a largely reasonable set of recommendations, but the power of the report and subsequent action by the British government illustrate our structural observation. LIBOR is the

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195. Bondi & Lofchie, *supra* note 193, at 168; *see also* Elizabeth L. Ritter, *The Securitization of Commodities: Crossing a Gold (or Silver) Line in the Sand*, 2 BUS. L. BRIEF 7, 8 (2005) ("'insider trading' means something very different in the securities world than it means in the commodities world (where it's actually desirable to have people with inside industry knowledge actively trading the marketplace — that's how prices are discovered). Consequently, application of securities insider trading laws to commodities trading is entirely inappropriate.").

196. *See, e.g.*, Bondi & Lofchie, *supra* note 193, at 168 (explaining that "commodity futures and derivatives markets exist to facilitate trading based on information generated by participants' inside knowledge").

world's short-term interest rate benchmark, and the LIBOR contributor banks include over half of the world's systemically important financial institutions, less than one-quarter of which are based in the United Kingdom.[197] The United Kingdom also accounts for less than half of the overall market value of global OTC derivatives.[198] Yet, it is the British government that retains the right to reformulate LIBOR, eliminate the BBA's control over it, and potentially (and disastrously) end LIBOR itself. By accident of history, the U.K. government could have abolished the world's most prominent interest rate and thrown millions of contracts into disarray.

However, exercising this leverage over international financial markets is risky. OTC derivatives markets are localized in London and New York,[199] and Bainbridge has claimed that aggressive control over LIBOR by the U.K. Treasury or Bank of England would meet with "political hostility" in the United States.[200]

From the perspective of the state under whose jurisdiction a transnational private regulator is headquartered, unique possibilities emerge. This jurisdictional reach provides a state with legal and regulatory power over a transnational private regulator. Control over the home of a transnational private regulator is thus a largely unacknowledged source of international regulatory power. A nation that seeks a certain character of regulation for the world's derivatives markets may well find that its best chance of achieving harmonized international regulation of that market is through leveraging control over a transnational private regulator.

Professor Robert Wai has characterized the broader reality of which this is just one instance — the necessity of even transnational private entities being subject to some measure of public jurisdiction — as the "touchdown" of transnational business, which seems to have partially "lifted off" from the plane of easy state law governance.[201] Wai cogently outlines several points of touchdown for private entities, including utilization of domestic law regimes to enforce contracts and property rights effectively, such as intellectual property or e-commerce.[202] The necessity of some "touchdown" entails that a public regulator will always

197. *About Us*, BBA LIBOR, http://www.bba.org.uk/about-us/member-list (last visited Aug. 6, 2013).

198. *See, e.g.*, Benjamin M. Weadon, *International Regulatory Arbitrage Resulting from Dodd–Frank Derivatives Regulation*, 16 N.C. BANKING INST. 249, 259 (2012).

199. *See* Baker, *supra* note 9, at 1321.

200. *See, e.g.*, BAINBRIDGE, *supra* note 115, at 40. Indeed, Bainbridge explicitly worries about "the thorny question of which government would take the lead." *Id.*

201. Biggins, *supra* note 54, at 1316; Robert Wai, *Transnational Liftoff and Juridical Touchdown: The Regulatory Function of Private International Law in an Era of Globalization*, 40 COLUM. J. TRANSNAT'L L. 209, 265 (2002).

202. Wai, *supra* note 201, at 265–66.

be able to assert power over financial markets principally regulated by a transnational private regulator. Likewise, Wai makes the point that these "touchdown" points are public regulators' opportunity to ensure that transnational private entities (and private regulators) are fully responsive to third-party concerns.[203]

John Biggins has drawn on Wai in the context of ISDA, noting "despite the best efforts of ISDA and the industry to minimize 'interpretative interference' through what I term 'targeted touchdown' . . . in what are perceived to be 'derivatives friendly' jurisdictions, particularly England and New York, such interference has been unavoidable."[204] Biggins emphasizes the potential hazards of public interference in transnational private regulation.

To our suggestion that LIBOR might be bolstered by U.S. property law, Bainbridge says

> [i]n the case of LIBOR, however, this suggestion makes no sense . . . . While the U.S. government obviously has an interest in such a globally and systemically important benchmark . . . it nevertheless makes more sense for any new intellectual property protections to come from LIBOR's home base rather than the U.S.[205]

Chris Brummer has expressed a similar view:

> ultimately the LIBOR scandal is an instance where the UK appears to be the most responsible authority since the British Bankers' Association, a local organization, provided the unique product in question . . . . London's Financial Services Authority was not a host, but was instead, for all practical purposes, the home regulator.[206]

This domestic power allows states to influence, shirk, and avoid responsibility for either. Brummer is right that: "[t]he home regulator won't get off scot-free [if there is a problem for the host country], but it will escape a lot of the scrutiny."[207]

The regulator with the greatest power to affect the transnational private regulation regime may sometimes have the least incentive to do so. If the home state is the beneficiary of the current transnational private regulator, then there is an incentive to allow its misbehavior at the expense of others. Thus, the Federal Reserve of New York may fail to curtail LIBOR

203. *Id.*
204. Biggins, *supra* note 54, at 1298.
205. BAINBRIDGE, *supra* note 115, at 47.
206. Chris Brummer, *London Is Better Off Reformed (LIBOR)*, HUFFINGTON POST (July 27, 2012, 1:53 PM), http://www.huffingtonpost.com/chris-brummer/london-banking-reform_b_1708229.html.
207. *Id.*

manipulation insofar as the beneficiaries are New York banks and the losers are global swap participants.

The global reach of regulation is exemplified by aspects of UBS's LIBOR settlement with the CFTC and the U.K. Financial Services Authority.[208] In that case, a U.S. regulator dictated to a Swiss Bank how its Japanese affiliate would communicate with a U.K. trade organization in connection with a benchmark used around the world. Thus, the substantive oversight of the benchmark-setting process is often achieved on a firm-by-firm basis, rather than at a national or industry level, where regulators have traditionally had power over the relevant firms.

I. Noticing Harmony

ISDA and the BBA have achieved massive harmonization of global derivatives norms. Realizing that there is non-state harmonization reveals the possibility that increased harmonization of state regulation may come at the expense of extant private regulatory harmony. It is an open question in any given instance whether that increased harmonization will result in a net increase in regulatory harmonization. For example, Dodd–Frank's efforts to create regulatory order has diverted transactions from better-harmonized spaces to less-harmonized ones. Under Dodd–Frank, many more OTC swaps must be cleared at registered clearinghouses, and entities that clear swaps through a Derivatives Clearing Organization must be registered Futures Commission Merchants.[209] Cleared swaps rely on futures account agreements rather than ISDA documentation, a fact that has resulted in some surprise and confusion to firms familiar with global swaps practice.[210] These changes resulted in a fragmentation of the practical order. This disharmony has since been managed by private regulators.[211] But policymakers must be aware that efforts to increase state regulatory harmony, even when they succeed on their own terms, may decrease harmonization *simpliciter*.

208. *See, e.g.*, UBS AG & UBS Sec. Japan Co., Comm. Fut. L. Rep. (CCH) ¶ 32,481 (Dec. 19, 2012) (order instituting proceedings pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act making findings and imposing remedial sanctions), *available at* http://www.cftc.gov/ucm/groups/public/@lrenforcementactions/documents/legalpleading/enfubsorder121912.pdf.

209. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 724a, 124 Stat. 1376, 1682 (2010).

210. *See, e.g.*, Lauren Teigland-Hunt, *When Worlds Collide: An Overview of New Industry Documentation for Cleared Swaps*, FUTURES & DERIVATIVES L. REP., Nov. 2012, at 1.

211. *Id.* at 5. FIA and ISDA published a standard form addendum to futures clearing agreements to address cleared swaps. *Id.*

CONCLUSION

The ambition of this Article was to explore the implications of a change in perspective on global derivatives regulation. The stage was set by reviewing the scholarly literature that recognizes authoritative governance of market activity, which is produced by private actors, as a genuine form of regulation. We then analyzed the BBA and ISDA as transnational private regulators that have produced coordinated, pervasive, and harmonizing norms for OTC derivatives. We suggested that this picture is more accurate than the history of OTC derivatives that has often been promoted in the media and scholarly literature, in which OTC derivatives were seen as subject to virtually no regulation at all. From this perspective, we articulated the many implications for future regulatory reform, including recognizing preexisting regulatory harmony, appreciating the extent to which trade-offs involved in regulatory proposals have already been considered, and muting the urge to willy-nilly regulate in times of crisis. With these tools, there can be modest hope for superior future governance of OTC derivatives.