Next 10 years: Where are we going?
January 26, 2019
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Chairs
Rita Molesworth (Willkie Farr)
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Panel:
Commissioner Rostin Behnam (CFTC)
Commissioner Brian Quintenz (CFTC)
Andrea Corcoran (Align International)
Micah Green (Steptoe & Johnson)
Steve Kennedy (ISDA)
ABA Winter Meeting: “The Next 10 Years: Where Are We Going”

January 26, 2019

“Gas-lighting\(^1\)” Ourselves—A Cinematic Retrospective,\(^2\) version 2.0

by Andrea M Corcoran \#no filter \(^3\)

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Its 2019 and remnants of The Great Financial Crisis or GFC—an acronym worthy of Roald Dahl’s BFG, continue to plague authorities world-wide. What have we learned? And what lies ahead? Let’s review the evidence, the lessons learned and un-learned, and take stock of whether we are still in the panic room or have moved to a quiet place\(^4\).

\(^1\) The term “Gaslighting,” is taken from the movie Gaslight (of which there is more than one version). In the 1944 movie, a husband (Charles Boyer) tries to convince his new wife (Ingrid Bergman) that she is imagining that the gas lights are flickering and that she is mentally unbalanced. Ms. Bergman is saved by Joseph Cotton, the “reliable detective” of noir film fame. The urban dictionary defines the term today as manipulating events (or other matters) in order to make a person think that their version of events is incorrect, indeed even crazy. Gaslighting as a term has been adopted by the #MeToo movement, but that is not its use here.

\(^2\) Can you identify the movies?

\(^3\) This presentation updates and refines an Article originally published by “Anonymous,” as part of a GFC anniversary compendium in the September 2018 Special Edition of the Futures & Derivatives Law Reporter. It was released to the public at the very moment that “Anonymouses” everywhere were getting a bad name. Of course, the pseudonymous author did claim responsibility in the final footnote. This version continues to protect the confidentiality of the several international contacts I polled to help me identify intellectually provocative references and to develop points to pursue. Their anonymity is meant to avoid burdening them with what some may consider hyperbolic conclusions and to permit them later to have plausible deniability in other forums. I continue to be grateful to my son Tom Corcoran for his research and Matthew for teaching me what “gas-lighting” means.

\(^4\) Skip to pages 4 for the principles-based rules and then to page 10 for the discussion of these if the background doesn’t interest.
Introduction. As a 40 year participant in the financial markets in the roles of regulator, academic, and policy maker—as well as—as an investor in the equity and debt markets literally since birth, it was with great trepidation that I accepted an invitation in August 2018 to reflect on lessons from the GFC from a decade of hindsight—and that hesitancy continued at year end as the Federal Reserve slims its balance sheet and ponders the right formula for setting interest rates. Today’s fervent political climate on all regulatory and deregulatory matters and my memory of applauding responses to the 1987 market crash on the eve of the 1997-1998 disruptions in Asia and at home alone continue to warrant that forecasts apply extreme caution.

If past personal experience with crisis occurring on the cusp of each decade were not enough to make any prognosticator wary, consider also that there have been financial crises in each of 1837, 1857, 1873, 1907, 1929, 1987, 1989, 1997, and 2007/8 and that strangely all of these events, and several others if one takes a global perspective, occurred autumnally in odd-numbered years—such as 2019. You can confirm this for yourself. The economists Reinhart and Rogoff, in their well-reviewed tome “This Time is Different,” chronicled 800 years of financial folly in 66 jurisdictions and made the spreadsheet data on which their conclusions are based publicly available for further analysis. Notably among this dispiriting list, almost one hundred percent were coupled with housing market distress and escalating debt and property/asset booms and busts. But then correlation is not causation, right?!

If this history by itself did not give one pause, none of these numbers counted titanic ripples due to major frauds, 9/11 or related geo-political upheavals in Syria, Turkey, Ukraine, and elsewhere. Nor does it include taper tantrums (2013), flash crashes (e.g., 2015), extreme market volatility (2018) or matters, such as, the ongoing drama following the March 2017 Brexit notice of UK withdrawal from the EU drawing nigh in the first quarter of 2019, with the UK politicos still as of December 2018 in a “deal,” “no deal,” or “no Brexit” posture of unreadiness. Additionally, this record did not address the unpredictability of non-establishment players on the international stage and whether “the centre cannot hold.” Foremost of these for many are Brexit issues that have continued to dominate discussions and roil internal and Scottish, Irish, and Gibraltar politics. Financial institutions in the EU and “the City,” continue to fret over the details and impact, with the Bank of England (BOE)recently expressing concern about the 2019 fate of 41 trillion pounds Sterling in derivatives risk that is reliant on UK CCPs and enhancing its uncertainty options, suggesting that Theresa May’s down to the wire “moment of truth” date with the politicians was and continues to be a major risk factor. Futuristically, none of the foregoing reflections mention the potential for future algo, cyber or crypto apocalypse or monetary (whether

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6 Kenneth S Rogoff and Carmen M Reinhart, “This Time is Different: Eight Centuries of Financial Folly” (September, 2009). Data is available in searchable form at l<http://www/reinhartandroff.com/data/>
7 “The Second Coming,” 1919, DW Yeats.
8 Note that “equivalence” as interpreted by the EU with respect to third country CCPs is also a front burner issue in the US, with the US CFTC in the forefront of those trying to seek a viable solution.
9 On October 10, and going forward via its Brexit report, the Financial Times indicated that while it thought that that moment had come, the process continued to move “the drop dead date” forward to various pending EU summits. Some who have experienced English negotiation techniques may note that it is not atypical for the English to only begin to seriously negotiate after “the ink is dry.”
10 Note the collapse of Bitcoin at the end of 2018, and a flurry of enforcement cases by the Department of Justice, the SEC, and the US CFTC against crypto initiatives and operations.
conventional or “unconventional”) policy failures, fall-out from re-indexing exchange index components, trade warfare, or political polarization, among other things. The XMen of finance, then, have yet to write the script that renders crisis and crisis prevention processes alien to finance or renders themselves obsolete.

Further cause for caution. The worries resurfacing ten years after the collapse of Lehman Brothers and beyond in our now “reality show governance atmosphere,” eerily echo prior nightmares on Wall Street. Worse, experts are querying whether some of the well-intended myriad of reforms years in the making might constrict available responses to crisis situations or blur who is in charge and who is accountable to whom. These prescriptions may also divert attention from the constants critical to protecting the financial system and its participants. For example, are the essential elements of risk and crisis management now lost in a myriad of detail? Are the regulators and the regulated being honest about how well they can manage these? Will the same misfortune befall today’s broad regulatory retractions as happened to those planned in 2007 which were hastily repackaged to address the subprime escalation?

The US Fed reassures that banks that hold 80% of assets in the US are strongly capitalized and can bear a severe economic downturn—or as the Wall Street Journal in late 2018 headlined “can withstand the worst!”11 Should the recent observation by competent authorities belittling the fact that three of our largest banks were apparently unable to pass recent stress tests raise concern12? In July, the current Chairman of the Board of Governors of the Federal Reserve opined that no bank is now too big to fail. Is he correct? Are industry advocates, regulators and pundits all gas-lighting13—deliberately dismissing, obfuscating, diverting, or understating the lay public’s observations of the risks that cause financial crises? Do these diversions and “discounting” prevent the risks from properly being met? Are these risks mere figments of our collective imagination or are we both the purveyors and the victims of a gaslight deception? Let’s see.

Background.

First Principles: Despite this history of volatility, upheaval, and surreal correlations, any rear window forecast must begin by acknowledging the continued resilience of the US financial markets, applicable legislation, and the related regulatory framework. Notwithstanding, the business cycle, new technologies, and the regulatory pendulum (all of which are notably pro-cyclical), the history of US market regulation and markets is a history of robustness in the face of dramatic evolutions, unforeseen threats, diabolical schemers, and other multiple challenges. It is also the history of a sometimes reluctant but effective community of interest between the regulated and their overseers in a properly functioning market.

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11 Page One, Wall Street Journal, Business & Finance section, June 22, 2018; see also Federal Reserve Chairman Powell’s remarks from Jackson Hole meeting of the Federal Reserve banks reported in July that today no bank is too big to fail.

12 Among others former Chairman, Janet Yellen has more recently expressed concerns about leveraged debt.

13 Apparently the Geneva Conventions on humanitarian issues take a dim view of gas-lighting as does the #MeToo movement for reasons unrelated to this article.
To prompt your memory, at the outset, in the early 1930’s a team of idealistic young lions—the FDR kitchen cabinet and prominent academics\textsuperscript{14} set down foundational principles for financial framework legislation over a single weekend. Then, through a longer, more contentious process these legal wordsmiths convinced the politicians of the day to enact them.\textsuperscript{15} The foresight-full mandates for securities—and indeed for financial regulation in general—they designed remain the basis of market health and fairness here and aspired to elsewhere today.

These first principles are:

- **Transparency** based on disclosure sufficient to permit fair evaluation of transactions so that buyers can make informed choices about price and risk—(Joseph Stiglitz owes his much later Nobel prize in economics to documenting the verity that the most transparent price is the most efficient price).\textsuperscript{16}

- **Proper, prompt and comparable accounting** for the financial condition of public companies and the capital strength of financial institutions—(real facts and real numbers to support real investment, risk, and business decisions),

- **Misconduct prohibitions—and related enforcement of these** on: (i) abuses of market power, (ii) misuse of client information, funds and property, (iii) provision of misleading and intentionally asymmetric information, and (iv) self-dealing due to conflicts—each exhortation intended to promote the integrity of brokered transactions, market prices overall and customer choices—(treating clients—and markets—fairly).\textsuperscript{17}

- **Coupled with, adequate protection of the banking, payment, and settlement system** essential to support the funding liquidity of so-called “mobile property,” such as equities, debt and financial instruments, and the integrity of transactions. This fourth existential pillar is designed to uphold the strength of financial institutions, prevent bank runs, support the irreversible transfer of securities and funds (e.g., delivery vs. payment), permit prompt monetization of gains and losses, and afford transactors reliable access to entrusted assets without resorting to safe deposit boxes or searching under the proverbial mattress—(transactional integrity).

\textsuperscript{14} Many East Coast professors and later Judge Frankfurter’s boys from Harvard, including Jim Landis, Ben Cohen and “Tommy the Cork” Corcoran among others, the latter two gracing the cover of Time Magazine Volume 11 in 1932. All of Wall Street camped out in the Mayflower hotel to oppose the securities market reform proposed so the process of making the legislation took way longer than the design. Corcoran and Cohen were also called the “hot dog” boys—see Washington Post editorial recalling them after Tom’s death (December 9, 1981).

\textsuperscript{15} In 1937, the cover of the New Republic referred to Corcoran and Cohen as the “Gold Dust Twins.”

\textsuperscript{16} And the gnomes of Central Banking have now embraced “forward guidance,” and greater transparency as to their determinations, largely at the instance of Governor Bernanke; Chairman Powell has added the nuance of so-called “neutral,” rate setting.

\textsuperscript{17} Conduct principles pertaining to banks are relatively limited as the Core Principles for Effective Banking Supervision focus largely on prudential issues. In 2015 a consultation on issues related to financial inclusion that might include conduct issues was conducted and concluded, but did not materially expand their scope beyond anti-money laundering issues. See www.bis.org, Committee on Banking Supervision. In 2018 the European Securities Markets Authority (ESMA) issued a paper detailing risks and supervisory approaches that includes conduct matters, especially related to complex products, binary options and contracts for differences.
Iteration of First Principles. Over time as crises in the financial sector recurred, the process begun in the 1930s to protect customers and the investment, market and payment system expanded to new products. Successive policy makers enhanced the framework to mitigate the risk that bank runs or funding illiquidity endemic to the banking business model, and/or settlement uncertainties or failures, would plunge the markets and related payments and financial commitments into disarray or worse.

For example, in 1968, the Commodity Exchange Act extended the statutory trust for customer funds whose segregation buttresses the integrity of futures transactions and markets to bank depositories as well as their brokers to prevent misappropriation of customer funds to cover extensions of credit to brokers by the bank. In 1971, the idea of an account compensation fund (the word insurance was forbidden) to prevent abrupt withdrawals of deposits with securities brokers or clearing gridlock from precipitating the failure of multiple intermediaries was adapted from the 1930 banking model. Beginning in 1978 business-friendly revisions to existing bankruptcy law were added. Amendments adopted prevent the reversal of good faith margin transactions, support portability of accounts and facilitate the continuation of payments due the market despite intermediary bankruptcies. These measures aspire to protect the market at large from a sick firm failure becoming a pandemic—that is, to foster continued payment of amounts due by healthy customers that in turn support continued performance of the marketplace as a whole.\(^\text{18}\)

The market crash of 1987, and the less precipitous domestic downturn in 1997, highlighted the critical need for these existential domestic protections. Further reforms enhanced data collection, mandated settlement finality, shortened settlement timeframes and augmented confirmation of proper treatment of customer funds (or segregation).\(^\text{19}\) Reforms also helped to mitigate potentially destabilizing market moves and later on to halt price cascades using circuit breakers or other limits.

The derivatives case. From the outset, legislation accorded special protections for presumptively risky derivatives products. When first regulated, exchange trading and clearing were mandated parts of domestic contracts. For futures, secure settlement remains critical to pricing integrity and the ability for commercial enterprises to hedge transactions efficiently and reliably. Central clearing typically “deleverages” risk daily, or more frequently, so that at each settlement open exposure is reduced to zero. This risk containment mechanism supports the ability to move positions from a failing to a healthy firm with alacrity in an emergency, has been tested time and again in the marketplace even in the direst of

\(^{18}\) The Part 190 Subcommittee of the ABA Futures and Derivatives Committee recently submitted proposed modernizations of these rules to the CFTC early this year in response to the Chair’s Keep it Simple (KISS) program. The rules package while modernizing and simplifying the rules text, supports the basic policy of mitigating the potential for contagion and retains the concepts intended to facilitate portability and to maximize the return of customer funds and the proper handling of deliveries. There are however some new Qualified Financial Product stay provisions which have yet to be tested in the marketplace.

\(^{19}\) See, Corcoran, A. “The Lessons of 1987: Thinking Back After a Decade of Response,” FDLR, Vol.17, No. 17 (October 1997) citing other articles and work on clearing for example; See also <http://www.sechistorical.org/sec/pdf/ar/2007_sechs_ar.pdf> which revisited these issues.
circumstances, and is reputedly the envy of crisis “copers” elsewhere. The central counterparty risk mutualization system incentivizes proper risk management (or as economists would say prudence “commitments”). Indeed, the 2009 Pittsburgh declaration by the Group of 20 embraced central counterparty clearing and related novation of bilateral exposures as a means of multi-lateral netting and a remedy to the funding, financial condition, and opaqueness uncertainties that had exacerbated the GFC.

It is within this background that the GFC legacy can be framed.

Crisis characteristics, settings and roles

Cause and effect. In addition to the G-20’s primal response, professionals and the public alike, at least on the western front, identified multiple risk factors that exacerbated the GFC. In addition to “externalities” like macro-economic and geo-political risk, these emphasized measurement risks such as undue reliance on untimely data, assumptions and related models leading to flawed values for intermediaries’ own, their counterparties’, and regulatory and others assessments of their positions.

Supervisory Cassandras avowed shock at the extent of gambling going on and lack of prohibitions on sketchy products that let holders bet on the demise of an entity whose death was the holder’s only interest. Groundkeepers rued the weeds among the 1000 flowers their constant gardeners let bloom. Critics queried the puniness in constant dollar terms of reserves, compensation and insurance arrangements. Pundits questioned the integrity and utility of gatekeepers like credit rating agencies and accountants who were hired to evaluate and/or “fair” price products by their promoters. Theorists decried the pro-cyclical need to raise margin to meet increased risks. And, ordinary people pondered whether Collateral Debt Obligations Squared, no-doc loans, and triple A ratings for securitizations of tottering layers of real estate mortgage tranches with questionably qualified borrowers separated in ways never contemplated by real estate conventions affecting junior and senior lenders, failed the Hemingway “bull s---t detector” test. Some commenters questioned whether trader/management compensation was so great that even Adam Smith’s self-interested man would remain untroubled by the prospect of his employer’s possible financial failure. Michael Lewis, memorably the author of “Liar’s Poker” which criticized the “big swinging dicks” of the wolves of Wall Street, documented all of this in his film “The Big


21 The Market Reform Act of 1990 gave the SEC certain powers that the US CFTC already had, for example, expanded emergency power and authority to obtain large position information on call. In the MF Global bankruptcy, some of the advantages of the CFTC Part 190 over SIPA (which does not provide “compensation” for futures accounts) were apparent.


23 More than one market participant has asked an intermediary, where did that price come from.

Short.” That film illustrates for the lay-public how the products “worked” until they didn’t, why raters gave them high marks, and how the potential ruse on the public became a joke on the designers and distributors themselves.

It seems, then, that the basics as laid out in the 1930’s and adapted to changing markets over time had been forgotten, mired in impenetrable complexity or, worse, intentionally evaded.

Responses

Urgent actions. The GFC oversight team invented a series of remedial actions on the spot to try to stem the downward spiral of events from “breaking” the system—ie., breaking the banc.25 That they were caught unawares, despite years of advocating risk-targeted supervisory approaches, is indisputable. It is also understandable in light of the extent of firm reserves and the mistaken paltriness of questionable operations that informed supervisory authorities’ predictions. They simply did not see the activities that would cause firms to fail and failures to multiply. Mitigating measures adapted to the moment included:

Central Bank acceptance of new categories of non-risk-free assets as collateral, (such as mortgage backed securities),26 which if valued by auction at the time might have required marking to market in a way that further destabilized and precipitated downward revaluations.

Government provision of temporary monetary support to prevent contagion and emergency liquidity to prevent insolvency of entities with clearing and custody roles or otherwise integrally connected to other pillars of the financial system that were not banks.

Rescue of institutions with at-risk financial institution counterparties in multiple non-US jurisdictions whose failure could further expand crisis domestically and abroad. And,

Quashing the specter of an exponential loss of confidence that would end “trust” and spur fire-sales and capital flight.27

These remedies were accommodated by flexible interpretations of market-tested law that allowed, even depended on, inventive responses taken on the ground. Applicable law as then read effectively permitted creation of ad hoc coping mechanisms for addressing the hard to predict exigencies of black swan (fat tail) events that seem a plague inherent to markets per the Reinhart-Rogoff litanies. In Europe Mario Draghi famously made his 2012 “whatever it takes” speech relative to protecting the economy and the union during the continuing crisis.

Longer term policy responses. The politicians of the G-20 endorsed central clearing of standardized OTC products and a medley of other initiatives, wresting the top-down role of setting financial policy from the supervisors. International implementation efforts outdid each other in

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25 A possible irony was that when bankers operated behind a “banc” or bench, breaking the bench actually meant that the bank was insolvent or done.

26 So-called Large Scale Asset Purchase Programs or LSAPs.

27 Effectively signaling all deposits (and mutual fund deposits) were insured—as did several other jurisdictions in the exigent circumstances of the moment. In fact, this is not unusual, the UK told depositors of Icelandic banks located in the UK that they would insure the deposits when Iceland said that they would only insure domestic deposits.
pronouncements of extraordinary girth. For example, in the US, the Dodd-Frank Wall Street Reform Act was adopted in 2010. The law contains 848 or 849 pages depending on whom you consult or cite and required multiple enormous rule-makings. By comparison, the 1965 act creating Medicare took 138 pages and The Securities Act of 1933, 93. The Volcker Rule is nearly 1,000 pages long. Compare this to the Glass-Steagall Act’s 37 pages, which successfully separated traditional commercial banking and investment banking and protected the banking system for 66 years. Volcker himself thought his eponymous rule was too complex and not proportionate and it has been progressively simplified.

Additionally, the provisions for an Orderly Liquidation Authority written into the law, added restraints or conditions on the options available to the authorities with which the overseers in 2008 were not burdened. These changes may constrain future emergency options available via then existing independent measures and powers of the financial authorities who compose the Financial Stability Oversight Council lead by the Secretary of the Treasury.

In the US alone many of the provisions implementing the GFC response have taken a decade and some will take longer if not withdrawn. For example, in October 2013, the law firm of Davis Polk found that regulators had missed 61 per cent of Dodd-Frank deadlines and by 2017, 20.5 percent had yet to be proposed. One 2012 commenter noted that if all the post-crisis requirements in the US and the EU were fulfilled the resulting six-figures worth of regulatory pages could require fast and furious adoption of policies and procedures, and concomitantly, compliance personnel to execute them. A global project of law that itself appears to be both too big to fail and to promise eternal job security to regulators.

Now, a decade later: has the set and scenario changed?

Back to the Future. Now that the high noon atmosphere is gone and we have walked ourselves back off the ledge, doubt as to the wisdom of the foregoing multiplication of prescriptive rules is waxing and zeal behind decade-old amendments is waning. In that some proposed remedies may have missed their mark, been overly detailed, disproportionate or politically or even turf motivated, advocates that Dodd-Frank and its global cohorts, can and even should be revisited are not surprising. A growing series


30 www.davispolk.org ;The Davis Polk Full Regulatory Tracker Website is now behind a paywall. According to the Davis Polk accounting, as of the seventh anniversary of Dodd-Frank, out of 390 total requirements, 280 (71.8%) had been met with finalized rules and for 30 (7.7%) more, a rulemaking was in progress. Rules had not then been proposed to meet 80 (20.5%) rulemakings.

31 Some changes have been deferred to 2020 and beyond. France recently protested the European Central Bank application of its leverage ratio to funds held for banks at the Caisse de depot. And in the fall of 2018, it was reported that the various EU authorities were engaging in a turf war as to who has the authority among them to supervise and regulate CCPs.
of whitepapers, position papers and wise men counsels evidence a wish to swing the regulatory pendulum back toward ground zero\textsuperscript{32}.

The trouble with remakes. In 2007, not content with the dramatic deregulations of 2000, policy makers in the midst of finalizing a 2006 white paper downsizing the Sarbanes Oxley prescriptions enacted to forestall failures like the Enron collapse in December 2001 had to abruptly change course. Promoters hastily retrofitted that report into a more remedial proposal reflecting experts’ increasing alarm at the depth of the subprime crisis. Subsequently, Larry Summers, Robert Rubin, Arthur Levitt and the then President’s Working Group, conveniently forgot or later publicly recanted (at least until the pendulum fully returns) that they supported the 2000 deregulations, which occurred while they were in office.\textsuperscript{33} But the lesson remains.

\textbf{2018 Intimations}

20-20 Hindsight is not foresight. Like portfolios past performance of regulators, regulatory processes and even time-honored legislation is not necessarily predictive of future success.

Further the toing and froing itself has a cost as the famous securities academic Louis Loss once lamented.\textsuperscript{34} And though any regime can benefit from change, the basic “bedrock” principles of capitalism’s ability to deliver a democratic marketplace remain relevant and do not as this analysis hopes to confirm.\textsuperscript{35}

Recently some global note-worthies sounded a variety of alarms about the current state of the post crisis financial eco-system. While these do not address application of the aforesaid bedrock principles, cited were numerous troubling trends which seem to call the principles into renewed prominence:

- the size of public and private debt,
- the return of “covenant free” lending,
- monetary and fiscal expansion, contraction and related market “tantrums,”
- “excessive” volatility and volatility aberrations,
- exposure of emerging markets to dollar debt or more broadly to excessive exchange rate risk,
- complex synthetic products, and
- the “inevitable” business cycle.

\textsuperscript{32} On July 19, 2018 the media announced a House financial reform act that received overwhelming bilateral support with less than 10 representatives demurring.

\textsuperscript{33} They also forgot they solicited a Congressional direction to forbid the USCFTC to inquire too deeply into or to ask too many questions about the possible risks of over-the-counter derivatives. Back in 1993 the CFTC had written a report identifying risk measurement issues in such products.

\textsuperscript{34} Professor Louis Loss, formerly of Harvard, the iconic compiler of securities law, now taken up by others.

\textsuperscript{35} Book Review Washington Post July 21, 2018, Roger Lowenstein review of “Bad Blood” by John Carreyrou re; the upheaval of a former darling of Silicon Valley, Theranos.
Additionally, they cited unintended consequences of regulation, compliance overload, decisional paralysis, resource constraints and ambiguities from so-called “boundary” or game of thrones problems related to the profusion of regulators, regulatory initiatives and their authors’ territorial ambitions (viz. money market funds, leverage restrictions, and clearing structures) at home and abroad.³⁶

More recently, even the architects of the US’s urgent response have questioned our, and our revamped laws’, current readiness to deal with the unexpected.³⁷ Each of these warnings advert to some disheartening statistics which suggest weaknesses reminiscent of, and in some cases more pronounced than, immediately prior to the GFC debacle, such as the current government debt to GDP ratio being twice that of 2007. Nor have regulatory turf wars ceased to wag the dog.³⁹

Reform or gas-lighting.

So are we still the way we were? Is it possible that we still have no real answer as to whether new processes and restrictions and changes in assigned government handlers will promote optimal choices to mitigate foreseen and unforeseen crisis if necessary? Will the newly contemplated changes stick? Are we better positioned today than during the calm before prior perfect storms? Did all that rulemaking and its complexity, like a spotlight deception, distract the policy makers from assessing whether they upheld the core principles of securities regulation and properly scaled and mitigated the GFC risks enumerated above?

Below are some broad rules to apply to determine the answer. Using these rules, and reconciling them to the four pillars and stalwarts of regulation we may be able to decide for ourselves whether today we are ready to meet the challenges of the future or whether we are blindsiding ourselves—again.⁴⁰

The Rules or First Principles:

Rule 1: Know thyself; be transparent, at least to yourself

Financial institutions not knowing their own position affected the scope of the GFC. Adequate self-knowledge of today’s complex financial structures includes knowing the potential risks from interconnected counterparties, businesses, and strategies. Lay people know that in normal times, one

³⁶ In futures parlance regulating US futures central counterparties as if they were banks.

³⁷ See May 14, 2018, 20th Anniversary Panel of the Toronto Centre, “Financial Stability and the Post-Crisis Reforms: Are we Done Yet?”-- webcast available at www.torontocentre.org. The panelists included Stefan Ingves, Governor of the Sveriges Riksbank (Central Bank of Sweden) and Chair of the Basel Committee on Banking Supervision; William (Bill) White, Chairman of the Economic and Development Review Committee at the OECD in Paris; Maureen Jensen, Chair and CEO of the Ontario Securities Commission; Kevin J. Stiroh, Executive Vice President of the Federal Reserve Bank of New York and head of its Supervision Group; Ceyla Pazarbasioglu, Senior Director in the Finance, Competitiveness and Innovation Global Practice of the World Bank Group; the Honorable Kevin G. Lynch, Vice Chairman of BMO; and moderated by John R Palmer, then Chairman of the Board of the Toronto Center.


³⁹ See for example, the June 17, 2009 Treasury Report, “Financial Regulatory Reform,” A New Foundation.”

⁴⁰ The Chart found at the end of the text compares each rule to the core pillars.
cannot borrow money from others without providing information on one’s total credit exposures—shouldn’t the same theory apply to indebting oneself?

Allegedly, confidentiality and privacy requirements, proprietary strategies and logistics make this ideal state of knowledge complex to achieve by commercial entities using financial instruments. And on these allegations, perhaps one of the best ideas—and perhaps the most flawed in execution-- of the proposed reforms seems to have foundered.

Position reporting to trade repositories that potentially could provide an aggregate view of credit exposures and leverage across the market is a main unfinished business of the GFC response. The impediments seen to date to achieving an acceptable outcome continue to multiply. Indeed, the likelihood of meeting the objective has been so widely deemed risible for its susceptibility to double counting and miss-counting as to cause a suspicious person to doubt whether the aim is not to fix it but to deem it a train wreck and to derail it altogether. This is true even though arguably, proper means of reporting positions to permit a view of aggregate exposures might be a simpler solution to opaqueness than some chosen priorities. Such reporting would have less potential for (i) creating new kinds of risk than proliferating clearing houses with potentially asymmetric (non-zero-sum) open exposure or for (ii) over-consolidating potential risks as some assert mandated central clearing for all may do.

The market itself views trade price reporting immediacy as critical. Remember, however, that as late as 2007 on the bank trading side, best practice was said to be confirming 85% of transactions within 5 days. Is it any wonder then that some risks were masked and that some losers, in the sense of misplaced or erased trades, were “lost” in big market moves? And do banks still permit traders to keep their trades on individual spread sheets?

The objectors imply that it is simply too complex for financial institutions to know their precise position promptly. This is not very comforting from the perspective of lay market users. Are we only imagining that if individual traders alone know what is at risk in a financial institution handling other people’s money that that is a problem both for the institution and its depositors? Losing 7.6 billion USD through not knowing has in at least one case been deemed trivial by financial experts, though unlikely to be deemed trivial by such institution’s users and funders. Have we made “not knowing” excusable, creating a negative incentive from a business, regulatory and public perspective?

41 In the last Century, the then iconic CBOT operated a system which had information on a clearing member by clearing member basis as to their margin surplus or deficit across all then operating futures markets daily, weekly, monthly, and quarterly for targeted surveillance of cross market risks.

42 At a recent symposium (October 2018) at the Chicago Federal Reserve Randall Kroszner established an analogy between the reforms related to the sinking of the Titanic (1912) and the unintended consequences leading in part to the 1915 disaster of the overloading and sinking of the MS Eastland, then docked, in the Chicago River, where 848 people died.

43 Brokers did not permit trade desks to have drawers to prevent brokers from “drawering” (deep sixing) tickets for their losing trades. While block chain advocates say they will form a superior immutable ledger, currently the transactions are not immutable until verified and this can take substantial time, especially as the chain lengthens and the mathematics is challenging to compute. Various groups are trying to change the verification methodologies to address this; but frankly existing real time capturing of trades in futures markets and related audit trails seem superior.
Stress testing is supposed to address this. But how can it if positions go unreported? Are our lay intimations correct that not knowing one’s own position is risky business? If so, shouldn’t this weakness be corrected?

**Rule 2: Examine both the forest and the trees**

The lay public understands the truth in the criticism of some reforms that collecting data for its own sake is a fool’s errand. For example, reformers, consumer advocates, and the public alike believe that the breadth of the Dodd Frank rulemaking may have reduced the accuracy of its aim.

In financial regulation too much information may obscure likely causes of malfeasance and risk. Noise—like the pervasive music (and related decibel ratings) now found in restaurants—might drown out rational supervisory judgment and thought. For example, too much information or untargeted information might frustrate adherence to the admirable principles of dealing with customers fairly and promoting price integrity. In fact, too much data can be as useless as none—as in the past when some exchanges designed exception metrics that outed so many false positives that none was capable of effective analysis or use for enforcement purposes?

Opposite the view that the forest can hide weak, problematic, and unhealthily contagious trees from view are the reg-tech and other advocates seeking to persuade us that deluges of information (big data, petraflops44 in a word) together with artificial intelligence (“AI”) and algorithmic programs to sort it can substitute for human judgment and grant our desire to know the meaning of everything.

There is no question that risk-based, smart methodologies of oversight by firms and by regulators as well are necessary. These require both having a high-level concept of what is risky and then a targeting methodology for determining where to look and how to measure what is found. While everyone agrees smart risk assessment is the goal, the smartest approaches are not that obvious. Additionally, too much technologically enabled and/or required data could inadvertently create undue access barriers to the market, result in use of potentially impenetrable proprietary methodologies and mire regulators in the matrix. Even more worrying, technological fixes may encourage regulators to rely on “the machine which goes ping45,” without understanding what that ping is all about46.

While in our information age, many claim more information, better information and more technology is progress— is this true? Can we analyze it all or will the AI body snatchers turn against us as the late Stephen Hawking and Elon Musk suggest?47 Are reams of data and regulators who know infinity better than selective prophylactic metrics or financial profiling for describing outlier conduct (such as out of trend activity) that requires further review? And what happens to the regulator who fails to see what lurks in the forest of data he or she or one has in house. In civil law jurisdictions they are at best chastised

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44 200,000 trillion calculations per second

45 Monty Python hospital skit in The Meaning of Life: https://www.youtube.com/watch?v=arCITMfxvEc

46 A criticism some have made of new methodologies, that many entrepreneurs are pursuing without explicit understanding as to how they work.

47 Recently the Wall Street Journal cited reports of Alexa turning on and off discussion, music, and appliances at her own discretion rather than on instruction.
for turning a blind eye or negligently failing to review the evidence and at worst, held personally liable, dismissed or criminally prosecuted48.

To get an idea of the magnitude of assessing all the evidence today, see the brilliant speech entitled “The Dog and the Frisbee.” and related tables from 2012 by Andrew G. Haldane, then Executive Director and Chief Economist of the BOE. His underlying analysis suggests we would need centuries to understand49 big data in a way that is helpful to making optimal choices in “unpredictable” situations if we try to use it all. Haldane is an advocate, like the retiring Chair of the CFTC, of keeping the regulatory process and regulation simple.

There are those who wish to convince us that more data is more knowledge. But we lay people who are not direct users of the information but beneficiaries of its usefulness to surveil markets and mitigate crisis situations can only conclude that the value proposition remains to be proved. Will more data just mean more phantasms? Will more data for the sake of data make it easier, or harder, to know what is happening in large institutions? And how will we know if we have too much, too little or the right stuff if we still do not even know what “is” is.50

**Rule 3. Cure the symptoms; avoid distraction by debates on cause.**

Initially the guardians of the public indicated that the aggregate exposure to sub-prime borrowers was so low it could not mathematically cause a systemic economic crisis.51 Unfortunately that assessment rested on evidence primarily based on real economy cash transactions occurring in the “real” housing market. The measurements did not take into account the “derivative” syndication structures which were being churned out by “syndication factories,” as one financial institution marketer labeled them. Did supervisors even suspect that no-doc loans were actively solicited for the explicit purpose of supplying these structures for “factory” assembly-liners? Were they aware that that purpose overwhelmed loans undertaken to make the American dream (a home of one’s own) more affordable, to comply with community banking injunctions, or underwritten on their own merits?

Even with the ensuing years demonstrating that this was the case, the revisionists of which there were, and still are many, allegedly have decided to divert the blame for the crisis to the “detestable” obligations of community banking and the poor fooling the experts as to the extent of the bad-debt risk in the system.52 The recent book ‘Fragile by Design,” by two Hoover Institute Stanford professors, which does have some interesting positions on the odd State/Federal issues in US banking as well as the agrarian Jeffersonian-federalist Hamiltonian divide, seems to take this approach. But as Jon Stewart once, perhaps apocryphally, is said to have quipped: all the mortgages in America could have been paid off for less than

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48 The worst happened to certain members of the Irish and the German authorities.

49 See n. 15 above, per Andrew G. Haldane in Jackson Hole. https://www.bis.org/reviews/r120905apdf

50 Note the Principles for Effective Banking Supervision, as amended/further explicated in December 2015 only address anti-money laundering and potential terrorist financing violations as conduct though they appear to worry about the impact on conduct of financial inclusion objectives. Banks continue to not have effective processes—see recent Danske and Deutsche bank cases.

51 This included two respective Chairmen of the Board of Governors of the Federal Reserve: Chairmen Bernanke and Greenspan among others.

what the crisis response initially cost the tax-paying public. So, the politics of causation may delay or lead to the wrong solution.

Did these theorists measure which came first the syndication package or the loan? Did they inquire about the feasibility of separating the first and second liens and packaging them in different investments? Did they question the policy of labelling bundled non-investment grade risks as investment grade so as to sell them to institutions whose investment policies limited them to investment grade investments? Did raters resist a separate category for structured debt to avoid such institutions’ boards having to revisit and/or amend their investment policies? The securitizations did supposedly remove problem loans from the initiators’ books. But rather than blame the debt or the underlying borrowers should we give more consideration to the fact that even the sellers of some of these complex products were dismayed when called to account. Some issuers even took back the worst of the products they sold to good customers reducing their reputational but augmenting their balance sheet risk and the potential for systemic consequences.

Blaming the dream of homeownership itself for the GFC seems not only excessive but also a gaslight deception.53 Were the victims who took the subprime tease mortgage loans which my smart phone spell checker transmuted into “surprise” loans54 the wrongdoers not the wronged? The intimation is, the problem was not us, it was you. No need to deal with the symptoms as there was no agreement as to their cause. Does the EMT need to conduct a physical before applying a tourniquet to a bleeding patient? Does this whole experience in fact make the business of banking ripe for a disruption?

Rule 4. Size does matter

Many authorities who have embraced risk-basing use multiple metrics. But, in order to predict the probability and impact of various types of disruptions, they all agree that one must have a view of the size of potential risk (its impact as well as its probability.) There is no argument about this. The basis for its application is in statistics and economics—the soft or dismal sciences. The Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) work illustrates various means to assess size metrics and identifies key risk factors.55 Nonetheless, it is possible that in the GFC, size was considered an antidote to risk. And inquiries as to the risks posed by exposures of bigger institutions were limited. Either way big is big.

Even now do we know precisely how much risk we shield by mandated protections, such as capital, buffers, emergency liquidity and other measures? But we do know that whatever these numbers were at the time, the Department of Treasury reported in 2009 that they simply were not enough56. While seemingly a justifiable inquiry, at a recent panel on the crisis during the Harvard Bicentennial Celebrations in 2017, when asked about how demonstrable the sufficiency of deposit insurance was today, no-one could say. Participants averred that it was politically impossible to test today’s measures against the

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53 In October 2018, various news programs highlighted the apparently mass program by Bank of America coupled with a community organizer to bring no deposit, below prime interest rate loans to 10,000 potential home buyers based in Florida. Hmm.

54 See the Marx Brothers film, Coconuts, about Florida real property boom where buyers were “stucco” for their home loans, also cited by Haldane.

55 Key Risk Indicators, See several Basel Committee on Banking Supervision reports, www.bis.org.

56 See n. 38 supra.
amount set in the 30s or to assess the validity of the methodology then used, against the potential size and likelihood of run risk impact in the aughts. (As an aside, is there any doubt among us that legislation always involves political judgments? Apart from the view that government sponsored enterprises caused the crisis by driving out private competition and consolidating risk, consider the extent of controversy—whatever one’s opinion on the outcome—over the establishment of the Consumer Financial Protection Bureau57 and probably less notably and more remotely the multiple pages in Dodd-Frank as adopted related to conflict mining and extractive fuels.58) When established the then deposit insurance amount of 150,000USD covered more than 90% of all existing deposits, reliably keeping deposits sticky and transferable to healthy banks. In constant dollars that amount would be more than two million today. It is not clear what percentage of run risk the increase from 150,000 to 250,000USD deposit insurance covers. Did anyone even ask? If not why not? 59 Politics is a reason, but not an excuse for uninvestigated policies.

For some, the intimation is that the lay public need not worry their lay heads whether their deposits will be safe in a crisis—they are sufficiently covered. Some cynics, however, would say that the politics of depositors finding out that they are unsecured creditors in the event of a bank failure should bank deposit insurance be insufficient is so politically unpalatable, why pay in advance. Don’t worry there will be a “bail out” (perhaps renamed for the occasion to be politically correct) despite all the rhetoric about moral hazard. In fact, all banks are politically too big to fail if their failure leaves domestic depositors at risk (See Northern Rock) notwithstanding conventional theory to the contrary.

The proof of the pudding is in the eating. Even, former Chairman of the Board of Governors of the Federal Reserve, Alan Greenspan, a noted libertarian, felt that the risk absorbing results of internal capital models should be tested against how well they actually worked in practice, and at one point discussed a charge back to capital where internal models did not. The original Basel II required non-standard, internal models to produce at least as much capital as the standard system. So some experts, even conservative experts, did not feel that we should take the size risk for granted or delegate counting the chickens to the fox.

Is this even more important in that the “gate keepers” who are accountable for proper valuations and calculations such as accountants and rating agencies who made cameo appearances during the GFC did not contest the integrity of management numbers (accounts and values and size) and were found even by the industry itself to require additional oversight.60

57 Why did this conduct oversight not go to the Securities and Exchange Commission?

58 Some of these have recently been “disappeared.”

59 To our knowledge only Cyprus, Argentina and Russia have considered not paying uninsured depositors affected by a bank failure politically acceptable and in Cyprus the holders of such accounts were not nationals. It is interesting however that there is a new book out by Sebastian Edwards entitled “the American Default: The Untold Story of FDR, the Supreme Court and the Battle Over Gold, where FDR went off the gold standard. Nixon, of course, devalued the dollar the second time we withdrew a peg when exiting Bretton Woods.

Hence our intimations that more certainty as to the potential size at risk, the strength of available remedies and funds in the worst-case scenario and the likely response would be desirable are not mere delusions. Systemically Important Financial Institutions, i.e., SIFIs, reflect this thought but how they will be treated in a crisis event remains to be seen.

Rule 5. Governance watchdogs are critical but no substitute for proper management

Some comics have said that like airline food, independent corporate governance is an oxymoron. At home and abroad, board oversight is now seen as the linchpin of public company protections of shareholder rights and company finances. In the financial sector area proper board composition and action are accepted as the armor against self-dealing and actions taken in conflict to proper exercise of the functions the institution performs as a public interest entity, that is, its public interest role relative to activities undertaken for clients and depositors not just shareholders. Board roles also now explicitly include oversight of cyber-security, risk assumption, and anti-money-laundering functions of management. Some jurisdictions even require the Board to take proper approaches to social policies, such as diversity, gender neutrality, conflict mining, climate change—and other interests, including employment/labor protections and social impact concerns.

But are our intimations correct that the degree of deference to the Board could let management off the hook? Or that the Board, at least in the US, can—as some wags have suggested—become the fan not the referee? Can a board that meets four times a year be even remotely capable of managing a company that many pundits believe is too big and too complex to manage by management on a day-to-day basis?

Is the intimation that we are no longer asking corporate Boards, especially financial services boards, to prioritize their fiduciary-like roles—set strategy, be a witness and barrier to bad conduct—correct? And how do we defend an interpretation of independence that permits three Fortune 500 CEOs from other companies to sit on an executive (CEO) compensation committee required to be composed of independent directors?

Rule 6. Business is global, but constituents and crisis politics are national

Magnificent work has been done at the international level to pre-empt the problems that lead to individual firm and systemic failure. This work includes standard-setting, memoranda of understanding on information sharing, IMF and World Bank financial sector assessments, enhanced capital requirements, and the development of networks of operational and technical personnel who know each other and can contact each other in the event of emergency. Nevertheless, notwithstanding supervisory colleges and MoUs, so-called accepted business wisdoms that there should be limited restrictions on capital flows, that branches are more efficient ways to employ capital than subsidiaries, and prompt, effective information sharing break down when in times of crisis there is uncertainty as to who has the money and who has the law suit.

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61 Simulations as well as stress tests might serve that purpose and a number of have been conducted, with varying results.

62 I am not fond of the term “risk appetite,” for this function as whose “risk appetite” are we talking about: clients (retail and wholesale), shareholders, bond-holders, bonus receivers, tax payers, the general public?
Despite calls from time to time to work on whether it is possible to develop an international regime for bankruptcy no viable regime has emerged and little progress has been made. Not only do national regimes have different views on the balance of interests in bankruptcy, but also the benefits of preventing a race to the till across borders remains a relatively unexplored legal wilderness.63

Now with the resurgence of populism and talk of not just Brexit, but “Qitaly,” “Euroviderci”, and Swexit, not to mention issues related to rule of law, judicial and election tampering, oligarch and boligarch flight, and corruption, are the nationalist challenges to amiable settlement of financial differences lessening? Are our intimations that where a failure occurs, no burden sharing regime exists as a matter of international or domestic law and there are insufficient assets to satisfy all claims in each jurisdiction, the result will be let’s share, or instead sauve qui peut or us vs. them?

**Rule 7. Barriers to the “everyone’s doing it” excuse are not necessarily a bad thing**

One commenter on commercial activity used the metaphor of Ulysses lashing himself to the mast and plugging the ears of his crew to drown out the siren song of what others are doing in describing marketplace risks.64 Millenial texters have a special message for fear of missing out (FOMO). In business the fact that everyone is doing it, if not an incentive, in operational fact is an excuse—the dark side of competition. Hence the strategy of many cultures to bring so-called “message” cases—that signal to the regulated community network when what everyone is doing is henceforward “not on,” (e.g., phasing out of Libor—though many still seem not to have gotten the message; reducing so-called celebratory trading, trading within the settlement period, et alia)65. Or to otherwise provide guidance to the Emerald City via the yellow brick road.

In practice, regulation can provide protection against risky competition by mandating best practice that for better or worse provides a commercial excuse to sales and profits personnel—a “why” for not doing “bad” things that everyone else supposedly is doing.

By virtue of limiting harmful competition “right-thinking” regulation can also be the solution to the problem that in the marketplace of ideas, people will meet the competition unless warned off by ground rules. Even though companies are commercially leery of competing on capital buffers, leverage limits, synthetic structures et al. they also may be afraid not to if that is where the market of the moment is. Afterall it was years before the syndicators excesses caught up with them.

Is our intimation that not all barriers are bad barriers misguided? Is it not true that often more guidance is sought by the industry when attempting to apply principles of good and prudential conduct to actual on the ground situations? Hence the 800-page guide to the principles-based approach to financial regulation in the UK. Isn’t it better for everyone to understand the ground rules applicability to themselves, their products and their actions? Are others seeing these flickers?

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65 Pricing of US variable rate mortgages at a discount or premium to Libor.
Rule 8. Test risk assumptions; don’t over trust past behaviors

We have been told that calling for extra margin in a crisis is destabilizing and pro-cyclical. While it is a truth that regulatory and creditor forbearance is often necessary to stem a crisis, pro-cyclical factors, not to mention the business cycle⁶⁶ are common market realities—even characteristic. For example, many esteemed arbiters (see the Warren Buffet bet)⁶⁷ believe (and demonstrably so) that buying the index passively is preferable performance-wise in terms of long-term costs and returns to active management of a securities portfolio and active balancing as opposed to stock picking also takes a similar tactical approach. But indexes, at least the large cap, main stock indexes, are unremittingly pro-cyclical and FAANG heavy to boot. The trend has been reliably upwards, albeit with several recent troubling hiccups and a few full out near death throes, that have roused some concerns as to causation. Experience shows that long term holders usually do not roil markets in the short term. BUT…. What goes up can come down. When it does, its downward trajectory is likely to overshoot, potentially confirming the potential negative effects of pro-cyclicality. Additionally, if everyone were to move to indexing instead of doing individual stock management such indexes could become unmoored like a derivative without an underlying further exacerbating inherent volatility, pro-cyclical and miss-pricing effects. After the September/October re-categorizing of tech as communication stocks in sector indexes and other index revisions can anyone doubt how indexes can push prices? And can anyone dispute that the tech stocks can push the market to overshoot.

At the same time as advocating passive investing, recently experts have said, we have a new equity bubble and the risk averse should flee to the risk-free bond. But is a bond, especially a long-term bond really risk free now that the Federal reserve is tightening. Corporate bonds and even some sovereign bonds are not liquid. In today’s environment we know that movement to more traditional monetary policies (that is in lay terms, more expensive credit and higher interest rates) is en train and hence bonds not only can but are likely to lose principal value.⁶⁸ This is true despite recent talk of the inflation target being too low and Shakespearean laments of persons in power.

Like what is—is, risk judgments depend on what risk is. If risk is the investment risk of losing money and one expects upward readjustments of the interest rates, then low interest longer term bonds are not risk free unless they can be held to maturity without default (not counting opportunity costs) under conditions where the government fiscal programs do not heist the value of money. Otherwise, per classic finance, the principal value of the bond will decline in the secondary market—if there even is a secondary market. These principles inform monetary policies, fiscal policies, and investment choices. The initial reactions to what were intentionally “surprise,” actions of the Central Banks showed sizable responses as the markets absorbed the policy news and adjusted. Market prices of securities typically, and operating normally, discount expected trends. Nonetheless, accelerated tightening or even the likelihood thereof may result in rebalancing portfolios and sometimes abruptly shedding instruments. We have seen this in emerging markets.

⁶⁶ See the discussion of the 1920’s et seq. economist, Kondratieff’s “wave” theory, which some has argued was economic gas-lighting. <https://en.wikipedia.org/wiki/Kondratiev_wave>

⁶⁷ Buffet bet was that an active manager could not beat the S&P index returns over a 5 year period. When played Buffet won.

⁶⁸ Some jurisdictions with huge rate escalations have resorted to a type of debt kiting due to the loss due to time costs of money.
Futures markets use multi-directional scenario analysis to identify risks, including outlier risks and binary risks. This is a highly useful means of determining where the risks lie and planning and provisioning accordingly. It is much better than the attitude of “not knowing” referred to above.

For the lay public, the intimations are don’t think too hard about these issues; we know better than you do. Pro-cyclical is as pro-cyclical does. It is bad when it means more margin to support open positions for us. It is good when it causes you to buy products. But both pro-cyclical realities exist and can be either reliably positive or negative depending on all the facts, the environment, the scenario and what is overshooting. We should not be gas-lighted out of examining our assumptions and the explanations of others and from using our own heads.

**Rule 9. Retain legal flexibility to react to the “unknown unknowns”**

We believe that the post GFC reforms at the least have provided a better route and forward planning to permit the wind down of failing businesses without losses to customers due to insolvency. But could we be mistaken about the future availability of money to provide emergency liquidity when needed, of the feasibility of maintaining stable institutions in a major melt-down, of the ability of Central Banks to cope. 69

The Orderly Liquidation Authority regime goes into place if a bank is insolvent for example. As at least one wag has said—all banks are insolvent all the time. If all depositors demand their money, all their money is not there. The Hank Greenberg case in the US Court of Claims decided both that he was not improperly compensated for the nationalization (claimed expropriation) of AIG but also that the type of actions in the AIG case (bailouts not just of AIG but assistance to its counterparties) were no longer available to resolve market emergencies. Many executive level decisions must be made in crisis situations. But now some of these may be unambiguously foreclosed.

The intimation is that extraordinary problems can be resolved without extraordinary measures. History and the histrionics of the crisis, such as Draghi’s do whatever is necessary seem to suggest the exact opposite.

It is hard to understand why foreclosing government (or even industry led rescuers’) monetary support is the proffered remedy to the GFC experience. One would submit that the Lehman case failure and the UK’s Northern Rock response to depositors lining up for the first time in over a hundred years to withdraw their money seems to demonstrate the exact opposite. Markets are fragile systems of trust. One must do what is necessary to maintain the trust—if not it will not be a wonderful life nor will Mary Poppins save Mr. Banks.

The assumption is that like brokers, banks will be wound down without loss to their depositors. But is that assumption correct? The capital structure of banks typically is different and resolution without money to support it, as someone quipped, may be as unusual as resurrection.

How are lay people to buy the theory that the emergency liquidity support that many believe would have saved Lehman Brothers from its ultimate collapse and mitigated, if not prevented, the impact

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69 In this respect, some thinkers have said that it is a mistake to call quantitative easing unconventional policy as that stigmatizes it. In their opinion such measures should be considered just another part of monetary policy makers overall toolkit. See panels on Monetary Policy at Brookings Institution on October 17, 2018.
on the global system of its failure would have been a heinous, moral hazard riven bail out? This seems even stranger when if one looks at the history of markets overall, the history has always included heroic rescues beginning in 1907 with JP Morgan and probably even before. Some analysts have posited that Lehman was not in fact insolvent and could have survived with some bridge lending support or time to execute a sale of its asset management business to a white knight or to give some leeway for a white knight to turn around a firm in peril. What are lay people to conclude that designating firms as systemically significant means if the government intends to let them fail nonetheless?

More problematically, to the extent Lehman imploded because of dependence on one day financing, the gas lights have not even flickered at the possibility that too much reliance on short term funding continues ongoing as a major risk-- the intimation being that we are deluded to think so.

Some might say in this case the delusion extends to the deluders who may have deluded themselves. Do they really believe that in appropriate circumstances bail-outs, and work-outs and emergency liquidity to assist restructurings and reorganizations and to incentivize White Knights are no longer necessary options despite years of experience that say otherwise? Doesn’t the GFC experience demonstrate that the flexibility to react to unpredictable events and even predictable ones is an essential component of crisis management? Do our governments want to acknowledge that doing what is necessary is impossible? As at least since 1907 some type of market or government rescue has been a response to crisis, how can we be so sure?

**Rule 10. Do no harm**

This speaks for itself. Every action has a reaction—and unintended consequences. The pervasiveness of this phenomenon underscores that policy makers should exercise caution in making changes as should the regulated entities in entering speculations and selling product and the buyers and end-users in making investments and buying from them.

Here is how the pillars of regulation fare when compared against the foregoing 10 proposed rules pertinent to any financial regulatory framework.

**Summary Chart: Reconciling ten rules of practice to four pillars of effective financial system oversight and avoidance of gas-lighting**

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<thead>
<tr>
<th>Rule</th>
<th>Transparency</th>
<th>Proper Accounting</th>
<th>Treating Clients Fairly</th>
<th>Systemic/prudential protections</th>
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<tbody>
<tr>
<td>1-Know thyself</td>
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<td>2-See both forest and trees</td>
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<td>3-Cure symptoms</td>
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70 See Texas Pacific Group’s interest in Washington Mutual being lost via FDIC proceeding to a government approved suitor.

71 See Rudyard Kipling and classic physics.
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<tbody>
<tr>
<td>4-Size matters</td>
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<td>5- Governance matters (but does not substitute for management)</td>
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<td>6-Business global; crisis response national</td>
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<td>7- Acknowledge barriers combat everyone’s doing it excuses</td>
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<td>8- Test assumptions; use spectrum of scenarios</td>
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<tr>
<td>9- Retain flexibility</td>
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<tr>
<td>10- Do no harm</td>
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*Nonetheless, valid arguments can be made that each pillar is relevant to each rule

**Conclusion.** Despite all we have learned from the perfect and imperfect storms we have weathered, we still need to continue to be wary of gas-lighters and gas-lighting. We must avoid letting a third-party rating or solicitation or academic conclusion override our own good judgment. Now it seems we have new instruments called leveraged debt, having changed the name to protect the innocent and ensure absence of malice. Further, the US Treasury and the US Congress have bonded to enact a number of Dodd-Frank reforms that among other things appear to make it easier to engage in community banking, which is very attractive to many sectors of the country and seems right-minded from a public policy perspective. One question to ask oneself, however, is are the intimations that we are missing the whole story here correct? Who will be selling the “derivatives” now permitted to be purchased on a proprietary basis by banks with assets of less than 10 billion dollars? Isn’t leveraged debt subprime debt? Haven’t we been here before? Are we crazy to worry that something could go wrong? Are there other issues that deserve attention. Can we be sanguine that crypto-losses, thefts, and defaults have only affected the dark net or a speculative few or should we be thinking about implications for the future.
But to talk about gas-lighting is only to hint at the real problem. The issues of high finance today are often too complex for the lay public and even some professionals and Boards to call out which fictions serve as truth and what are not fake or alternative facts. One cannot speak truth to power if one does not know what the truth is and cannot find out.

None of the longstanding rules that support the four first principles stated above is new. And every manager, board member and compliance person should know what they are. Even Marco Polo in the 14th Century knew he had to know where his credit was coming from. What is interesting is that even though these ten rules are as critical to businesses as well as regulators, customers and the general public, they often continue to be honored in the breach as often as in the observance.

But perhaps all will turn out to be all right in the end— and if it has not yet, it is not the end. (Best Exotic Marigold Hotel-2011) Or perhaps that is the challenge--- to keep in mind all of the questions posed above, to keep our eyes wide open and to flush out the gas-lighters as needed to keep the system going and the benches (bancs) unbroken.

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72 See Chart above text.

I. INTRODUCTION

The Commodity Futures Trading Commission (“CFTC”) and Securities and Exchange (“SEC”) have moved at very different speeds to implement changes added to their respective statutes – the Commodity Exchange Act and federal securities laws – by the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”). The CFTC completed the bulk of its swaps-related rules by early 2017. Although it is still finalizing certain rules (and adopted some in 2018), it is now in a position to evaluate how well most of the rules it adopted are working, and is considering whether changes may be appropriate to those rules.

The SEC has also adopted many rules relating to security-based swaps, but rules in a number of important areas are still open. Moreover, the SEC conditioned implementation of certain key rules it has finalized on its adoption of other rules. Specifically, rules for registering and regulating security-based swap dealers (“SBSD”) and major security-based swap participants (“MSBSPs”) and the security-based swap transaction reporting rules will only come into force once the SEC adopts (i) rules prescribing capital, margin and segregation requirements for SBSDs and MSBSPs, (ii) rules prescribing recordkeeping and reporting requirements for SBSDs and MSBSPs, and (iii) a procedural rule for obtaining an order to permit an associated person of an SBSD or MSBSP who is subject to statutory disqualification to be able to effect security-based swap transactions.

The SEC is reviving its efforts to complete its Dodd-Frank rulemaking. This was signaled in a speech by SEC Commissioner Hester Peirce on October 4th at the 2018 ISDA Annual North American Conference, in which she announced that she is leading the SEC’s Dodd-Frank rulemaking efforts, at SEC Chairman Clayton’s request. Putting a positive spin on the SEC’s slow progress, she notes that the SEC can learn from the CFTC’s experience (and the experiences of regulators in other jurisdictions) to avoid making some of their mistakes, and “identify differences with the CFTC’s rules, and those in other jurisdictions, and to work toward reducing the likelihood of unnecessary friction, whether due to duplication of—or conflicts between—our rules.”

The SEC’s initial focus is on finalizing rules in the three areas listed above, so that it may finally implement the SBSD/MSBSP rules and transaction reporting rules. To that end, in October, the SEC reopened the comment period on its capital, margin and segregation proposals for SBSDs and MSBSPs (“2018 Re-Proposal”), and in December, it adopted the procedural rule mentioned above. Separately, representing another important rulemaking initiative, the SEC in December proposed rules imposing risk-mitigation obligations on SBSDs and MSBSPs for non-cleared security-based swap transactions.

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1 The author wishes to thank her colleague, Michael Bresnahan, for his assistance with the research for this paper.
3 Id. at 2.
II. STATUS OF SEC DODD-FRANK RULEMAKING

Rules Adopted

The SEC has adopted many rules to implement the regulatory regime for security-based swaps. Specifically, it has adopted rules in the following areas:

- In 2012 and 2014, definitions in SEC Rules 3a67-1 through 3a67-10, Rules 3a68-1a through 3a68-5, Rules 3a69-1 and 3a69-2, and Rule 3a71-3.  

- In 2012, a rule setting out the process for reviewing a clearing agency’s submission for clearing security-based swaps (Rule 19b-4(o)(1)), and related rules on the clearing requirement for security-based swaps (Rules 3Ca-1 and 3Ca-2).  

- In 2012, standards for clearing agencies, set out in Rule 17Ad-22.  

- In 2014, certain definitions (covered in the first bullet point) and related rules and interpretations relating to cross-board application of the definitions to SBSDs and MSBSPs, including a procedural rule for a firm to apply for a substituted compliance order, and a rule setting out the SEC’s cross-border law enforcement authority (included in Part 250 of its rules). In 2016, the SEC adopted certain amendments relating to transactions arranged in the U.S.  

- In 2015, registration rules for SBSDs and MSBSPs, set out in SEC Rules 15Fb1-1 through 15Fb6-2, along with related forms.  

- In 2015, rules governing security-based swap data repositories, set out in Rules 13n-1 through 13n-12, as amended in 2016 with respect to access to data obtained by a security-based swap data repository.

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7 Clearing Agency Standards, 77 FR 66220 (Nov. 11, 2012).  


9 Security-Based Swap Transactions Connected with a Non-U.S. Person’s Dealing Activity That Are Arranged, Negotiated, or Executed by Personnel Located in a U.S. Branch or Office or in a U.S. Branch or Office of an Agent; Security-Based Swap Dealer De Minimis Exception, 81 FR 8597 (Feb. 10, 2016)  


11 Security-Based Swap Data Repository Registration, Duties, and Core Principles, 80 FR 14437 (Mar. 19, 2015)  

12 Access to Data Obtained by Security-Based Swap Data Repositories, 81 FR 60585 (Sept. 2, 2016).
In 2015, rules on reporting of information for security-based swap transactions and dissemination of such information, as amended in 2016, set out in Regulation SBSR.

In 2016, business conduct standards for SBSDs and MSBSPs, set out in Rules 15Fh-1 through 15Fh-6, and designation and responsibilities of a chief compliance officer for an SBSD or MSBSP, set out in Rule 15Fk-1.

In 2016, trade acknowledgement obligations for SBSDs and MSBSPs with respect to security-based swap transactions, set out in Rules 15Fi-1 and 15Fi-2.

In December 2018, Procedural Rule 194, which sets out the process for an SBSD or MSBSP to apply to the SEC for an order that would permit an individual who is an associated person of the firm and is subject to a statutory disqualification to effect or be involved in effecting security-based swap transactions on the firm’s behalf. The rule also provides that an SBSD or MSBSP may allow a statutorily disqualified individual to effect or be involved in effecting security-based swap transactions without going through the application process, subject to conditions, if the CFTC or National Futures Association has granted relief from statutory disqualification to the individual as an associated person of the firm.

As mentioned, though, the rules for SBSDs and MSBSPs and for security-based swap transaction reporting are not yet operational, representing significant gaps in implementing the Dodd-Frank regime for security-based swaps.

Pending Rules

The SEC also has a number of major Dodd-Frank rulemaking proposals pending. In addition to the proposed capital, margin and segregation rules covered by the 2018 Re-Proposal (discussed in the following section), the following rules (among others) have been proposed and are pending:

- Proposed anti-fraud rule, Rule 19j-1, which would prohibit the same misconducted covered by Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1935, with respect to “the ‘exercise of any right or performance of any obligation under’ a security-based swaps.”

- Proposed Rule 3Cg-1 governing the end-user exemption from mandatory clearing of security-based swap transactions.

- Proposed rules for security-based swap execution facilities.

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16 Trade Acknowledgement and Verification of Security-Based Swap Transactions, 81 FR 39808 (June 17, 2016).
18 Prohibition Against Fraud, Manipulation, and Deception in Connection with the Security-Based Swaps, 75 FR 68560 (Nov. 8, 2010).
19 End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 FR 79992 (Dec. 21, 2010).
20 Registration and Regulation of Security-Based Swap Execution Facilities, 76 FR 10948 (Feb. 28, 2011).
• Proposed amendments to various rules to set out recordkeeping and reporting obligations for SBSDs and MSPSBs.\textsuperscript{21}

• Proposed Rules 15Fi-3 through 15Fi-5, which would impose certain risk-mitigation obligations on SBSDs and MSBSPs for non-cleared security-based swap transactions, along with proposed amendments to Rule 3a71-6 to allow for potential substituted compliance with those obligations and a proposed interpretation for applying portfolio reconciliation, portfolio compression and trading documentation requirements to cross-border activities in security-based swaps.\textsuperscript{22}

Comments will be due 60 days after the release is published in the Federal Register.

III. \textbf{THE 2018 RE-PROPOSAL OF PROPOSED CAPITAL, MARGIN AND SEGREGATION REQUIREMENTS FOR SBSDS AND MSBSPS}

As noted, the SEC recently reopened the comment period on earlier rulemaking proposals relating to capital, margin and segregation requirements for SBSDs and MSBSPs. The comment period closed on November 19, 2018. The SEC received around 25 comment letters, including letters from FIA, SIFMA and ISDA.

The 2018 Re-Proposal covers three related rulemaking releases:

1. In 2012, the SEC proposed rules to establish (i) capital and margin requirements for SBSDs and MSBSPs that do not have a prudential regulator (i.e., nonbank SBSDs and nonbank MSBSPs); (ii) segregation requirements for SBSDs; and (iii) notification requirements for SBSDs and MSBSPs relating to segregation ("\textit{2012 Proposals}").\textsuperscript{23}

2. In 2013, the SEC proposed rules for applying capital, margin and segregation requirements to cross-border transactions ("\textit{2013 Proposals}").\textsuperscript{24}

3. In 2014, the SEC proposed additional capital requirements for nonbank SBSDs ("\textit{2014 Proposal}").\textsuperscript{25}

In the 2018 Re-Proposal, the SEC requested comments on specific features of the earlier proposals. The following summary covers a number of the issues on which the SEC requested input.

\textbf{Proposed Capital Requirements for SBSDs}

\textit{Revisions to the 8\% Risk Margin Amount.} In the 2012 Proposals, the SEC proposed imposing a “financial ratio-derived minimum net capital requirement” on nonbank SBSDs, equal to 8\% of the firm’s risk margin amount. The SEC proposed that the component of the risk margin amount covering cleared security-based swaps transactions would be the greater of a clearing agency’s total margin requirements for customers’ cleared security-based swap positions or the haircuts that apply to the positions under the proposed capital requirements. In the 2018 Re-Proposal, the SEC requested comment on whether to modify this part of the

\textsuperscript{21} Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, 79 FR 25194 (May 2, 2014).

\textsuperscript{22} Release 34-84861, Risk Mitigation Techniques for Uncleared Security-Based Swaps (Dec. 19, 2018).

\textsuperscript{23} Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 FR 70214 (Nov. 23, 2012). The SEC also proposed certain changes to net capital and liquidity requirements for broker-dealers permitted to use internal models to compute net capital.

\textsuperscript{24} Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants, 78 FR 30968 (May 23, 2013).

\textsuperscript{25} Recordkeeping and Reporting Requirements for Security-Based Swap Dealers, Major Security-Based Swap Participants, and Broker-Dealers; Capital Rule for Certain Security-Based Swap Dealers, 79 FR 25194 (May 2, 2014).
risk margin amount calculation to cover a clearing agency’s margin requirements only, to “simplify the calculation, align it with the clearing agency margin requirements, and more closely align it with the CFTC’s existing rules and proposals.”

The SEC also requested data on the minimum net capital amounts potentially required under the SEC’s proposal, and how they compare with capital maintained by firms that may register as nonbank SBSDs.

**Risk-Based Capital Charges.** The SEC requested comment on whether to modify a proposed capital charge in the 2012 Proposals the would apply to a nonbank SBSD if it collects margin from a counterparty to a cleared security-based swap that is less than the amount of the haircut that would apply to the transaction if it were a proprietary position of the firm. The SEC is considering whether to include a risk-based threshold defining circumstances under which a nonbank SBSD would not have to take the proposed capital charge.

**Credit Risk Charge for Non-Cleared Transactions.** Under the 2012 Proposals, a nonbank SBSD must take a 100% capital charge with respect to non-cleared transactions in security-based swaps when it does not collect variation margin or initial margin for those transactions because of an exception from having to collect margin. Alternatively, a nonbank SBSD that uses an internal net capital calculation model could take a credit risk charge when the uncollected margin involves transactions with a commercial end-user. In the 2018 Re-Proposal, the SEC requested comment on whether to make the alternative credit risk charge available for transactions with other types of counterparties, and whether it should adopt a threshold for uncollected margin (e.g., 10% of tentative net capital) above which a nonbank SBSD could not use the alternative credit risk charge.

**Capital Charge for Segregated Initial Margin for Non-Cleared Transactions.** In the 2012 Proposals, the SEC proposed imposing a capital charge on a nonbank SBSD when a counterparty to a non-cleared security-based swap transaction requires the firm to hold the initial margin it posts on a segregated basis with an independent third-party custodian, because the nonbank SBSD would not be in possession or control of the collateral. In response to comments that the capital charge will discourage the use of segregation and result in increased costs for customers as SBSDs seek to cover the capital charge, the SEC has asked whether it should adopt an exception to the capital charge when: (i) the custodian is a bank; (ii) there is an agreement among the nonbank SBSD, custodian and counterparty giving the nonbank SBSD control over the collateral; and (iii) the agreement is deemed enforceable by an opinion of counsel.

**Capital Charge for Posted Margin.** In the 2012 Proposals, the SEC proposed that a nonbank SBSD must deduct the value of initial margin it delivers to a counterparty from the firm’s net worth when computing its net capital. In the 2018 Re-Proposal, the SEC requested comment on whether there are circumstances under which a nonbank SBSD could post margin without incurring the capital charge. The SEC specifically raised whether the capital charge should not apply under the circumstances set forth in a 2016 no-action letter issued by the SEC Division of Trading and Markets granting relief to a broker-dealer with respect to margin posted to a counterparty for a non-cleared swap, specifically, if “(1) [t]he initial margin requirement is funded by a fully executed written loan agreement with an affiliate of the broker-dealer; (2) the loan agreement provides that the lender waives re-payment of the loan until the initial margin is returned to the broker-dealer; and (3) the broker-dealer’s liability to the lender can be fully satisfied by delivering the collateral serving as initial margin to the lender.”

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26 83 FR at 53009.

27 See Letter from Michael A. Macchiaroli, Associate Director, Division of Trading and Markets, Commission, to Kris Dailey, Vice President, Risk Oversight and Regulation, FINRA (Aug. 19, 2016).
Margin for Non-Cleared Security-Based Swap Transactions

**Margin Calculations.** In the 2012 Proposals, the SEC proposed requiring a nonbank SBSD to calculate a daily initial margin amount for non-cleared security-based swap transactions for each counterparty using standardized deductions or model-based deductions set forth in the proposed capital rule, with the exception that the standardized deductions must be used to calculate initial margin for equity security-based swaps. In response to comments, the SEC has asked if it should modify the margin rules to permit a nonbank SBSD to apply to the SEC for permission to use other models for calculating initial margin, including a standard industry model. The SEC noted that the corresponding margin rules adopted by the CFTC and prudential regulators permit the use of other models, and that dealers subject to those rules “have widely adopted the use of an industry-developed uniform model to compute initial margin.”\(^{28}\)

**Risk-Based Thresholds for Collecting Initial and Variation Margin.** The 2012 Proposals contained a proposed rule under which a nonbank SBSD must collect initial and variation margin from each counterparty to a non-cleared security-based swap transaction, unless the counterparty: (i) is a commercial end-user; (ii) is another SBSD; (iii) requires segregation; or (iv) holds only legacy transactions in its account. The SEC requested comment on whether to add a risk-based threshold below which a nonbank SBSDs is not required to collect initial margin, e.g., if the amount is less than 1% of the firm’s tentative net capital and 10% of the counterparty’s net worth.

**Margin Collection Exceptions When the Counterparty is another SBSD.** In the 2012 Proposals, the SEC proposed two alternatives under which a nonbank SBSD would not be required to collect margin from a counterparty that is an SBSD: (i) the counterparty is an SBSD, without further qualification, or (ii) the counterparty is an SBSD and the initial margin is segregated with an independent third-party custodian. In the 2018 Re-Proposal, the SEC requested data to help it quantify the economic impacts of the two alternatives. It also asked for comment on whether to expand the class of counterparties under the first alternative, to include counterparties that are broker-dealers, banks, futures commission merchants (“FCMs”), foreign banks, or foreign dealer counterparties, to promote the liquidity of such market participants by reducing the amount of capital they are required to post to counterparties as initial margin.

**Portfolio Margining.** In response to comments, the SEC sought input on whether it should permit portfolio margining for swaps, security-based swaps and related positions. Specifically, it requested comment on the following scenarios in which a firm could hold swaps and security-based swaps (and presumably related positons) in the same account and establish the margin for the account on a portfolio basis:

- Swaps held in a security-based swap account at a firm that is a broker-dealer, nonbank SBSD and swap dealer.
- Security-based swaps held in a swap account at a firm that is an FCM, nonbank SBSD and swap dealer.
- Swaps held in a security-based swap account at a firm that is a nonbank SBSD and swap dealer, but is not a broker-dealer or an FCM.
- Security-based swaps held in a swap account at a firm that is a nonbank SBSD and swap dealer, but is not a broker-dealer or an FCM.

\(^{28}\) 83 FR at 53013.
The SEC also asked whether it should permit the firm carrying the account to use a model to determine portfolio margin requirements for security-based swaps and swaps, if the accounts do not hold positions in cash market equity securities or listed options.

**Segregation**

**Omnibus Segregation Requirements Alternative.** As an alternative to third-party custodial segregation, the 2012 Proposals provide that an SBSD could hold initial margin for non-cleared security-based swap transactions received from counterparties under requirements modeled after the SEC’s broker-dealer customer protection rule, Rule 15c3-3, tailored to security-based swaps. The SEC requested comment on whether there are aspects of the proposed requirements where it should provide clarification.

**Cross-Border Application of Segregation Requirements.** In the 2013 Proposals, the SEC proposed applying the segregation requirement on a foreign SBSD or foreign MSBSP based on whether the firm is a registered broker-dealer, a U.S. branch or agency of a foreign bank, or neither, and whether a security-based swap transaction is cleared or non-cleared. The SEC requested comment on whether it should provide greater clarity on how the proposed cross-border rules would apply.

Under the 2013 Proposals, a foreign SBSD that is a U.S. branch or agency of a foreign bank would have to comply with the segregation requirements with respect to security-based swap transactions with U.S. security-based swap customers, but not those with foreign security-based swap customers. The SEC requested comment on whether a foreign SBSD that is not a broker-dealer but is a foreign bank should have to comply with the segregation requirements under the following scenarios:

- Transactions with a U.S. security-based swap customer, regardless of the branch or agency out of which the customer’s transactions arise, or
- Transactions with a foreign security-based swap customer, if the foreign SBSD holds the funds or other property arising out of the transaction with a U.S. branch or agency of the foreign SBSD.

**Excess Securities Collateral.** Under the 2012 Proposals, an SBSD must maintain physical possession or control of “excess securities collateral,” subject to certain exceptions, and must also perform a customer reserve calculation under a prescribed formula. The SEC has requested comment on aspects of the proposed requirements.

**Haircut for Customer Reserve Accounts Held at a Single Unaffiliated Bank.** Under the 2012 Proposals, an SBSD would have to deduct the amount of funds held in a security-based swap customer reserve account at a single bank to the extent it exceeds 10% of the bank’s equity capital as reported in its most recent Consolidated Report of Condition and Income. The SEC later modified its broker-dealer counterpart rule, Rule 15c3-3, to increase the threshold for broker-dealer customer reserve accounts held at a bank to 15% of the bank’s equity capital, and to exclude cash deposited at an affiliated bank. The SEC requested comment on whether to make corresponding changes to the proposed rule for SBSDs, for consistency.

**Substituted Compliance**

In the 2013 Proposals, the SEC proposed making substituted compliance available to a foreign nonbank SBSD that is not registered as a broker-dealer, with respect to capital and margin requirements. If the SEC makes a substituted compliance determination, the foreign SBSD would be deemed to meet SEC requirements if it complies with relevant capital and margin requirements under an applicable foreign regulatory system. The SEC requested comment on whether the modifications it is considering under the 2018 Re-Proposal could impact making substituted compliance determinations. The SEC also requested comment on the factors to consider when making substituted compliance determinations.
Cross-Border Issues Relating to the CFTC’s Recent Proposal on CPO Registration Exemptions

Rita M. Molesworth and Michael A. DeNiro

Since the financial crisis and partly in response to the mandates of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Commodity Futures Trading Commission (“CFTC”) has promulgated a significant number of new rules and regulations, no-action and interpretive letters and other forms of guidance. These actions, together with similar actions by other U.S. and non-U.S. financial regulators, have led to an increasingly complex regulatory landscape. For a number of market participants, particularly those engaged in cross-border activities, this increasing complexity has resulted in greater compliance burdens and, at times, legal uncertainty. For example, some market participants engaged in cross-border swaps transactions continue to face challenges in determining the applicability of the CFTC’s regulatory regime to their activities based on the CFTC’s existing guidance.

In 2017, the CFTC initiated Project KISS, an agency wide effort to modernize and make the CFTC’s regulatory process more efficient. The goal of Project KISS generally is to examine the CFTC’s existing rules and apply them in a manner that is simpler and less burdensome for market participants. The Project KISS initiative has resulted in a number of regulatory developments, including a simplification of the CFTC’s primary definitions regulation, Chairman Giancarlo’s white paper on cross-border swaps regulation and the CFTC’s recent proposal on commodity pool operator (“CPO”) and commodity trading advisor (“CTA”) registration requirements (discussed below).

While the Project KISS initiative is likely to result in further improvement of the current regulatory framework, and may reduce overall complexity while still safeguarding markets, there is still much

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1 Rita M. Molesworth is a partner and Michael A. DeNiro is an associate at Willkie Farr & Gallagher LLP in New York.
work to be done, particularly in the cross-border context. As some have noted, the post-Dodd-Frank response to swaps regulation, in particular, has led to an overall fragmentation of the market and multiple liquidity pools, which generally increases trading costs and impacts the ability of market participants to effectively manage risk.\(^5\) While different regulatory approaches across jurisdictions were prevalent immediately following the financial crisis, in recent years there has been an overall convergence among developed countries with respect to their regulation of the swaps markets.\(^6\) This beneficial convergence should prompt regulators, including the CFTC, to think critically about the best manner in which to allocate responsibility for the oversight of markets and market participants, and to work together to create appropriate and effective regulatory borders.

This goal of increasing legal certainty, reducing compliance burdens and practicing appropriate deference to home country regulators should not be limited to the swaps markets, however.

In October 2018, the CFTC proposed new rules that would, among other things, codify certain exemptive relief available to the non-U.S. operators of non-U.S. commodity pools under CFTC Advisory 18-96 (the “Proposal”).\(^7\) The Proposal is related to the Project KISS initiative and, according to statements by Chairman Giancarlo, aimed at “reduc[ing] burdens for CPOs that operate pools in multiple jurisdictions by permitting them to register with respect to the pools that solicit or accept U.S. domiciled participants.”\(^8\) As discussed below, however, practitioners are concerned that certain aspects of the Proposal might have the effect of bringing offshore commodity pools with no nexus to the United States within scope of the CFTC’s jurisdiction. This would ultimately run counter to the CFTC’s long-standing practice of focusing its resources on protecting U.S. customers and leaving the protection of non-U.S. customers to their respective home country regulators. It would also increase complexity for market participants that operate globally, which would appear to contradict the goals of Project KISS.

\(^5\) See id. at 16. See also American Bar Association Business Law Section, Derivatives and Futures Law Committee, Comment Letter re: Project KISS Input – Miscellaneous (RIN 3038-AE55) at 7 (noting that, in recent years, “separate U.S. and non-U.S. pools of liquidity have developed in certain markets” and that “[t]he existence of multiple liquidity pools generally increases trading costs and complicates the ability of market participants to effectively manage risk, particularly during periods of market stress”).

\(^6\) See Swaps White Paper at 7 (“Even in 2013 when the CFTC published the CFTC Cross-Border Guidance, very few non-U.S. jurisdictions had made much progress in implementing the global swaps reforms that were agreed to at the Pittsburgh G20 Summit. Today, however, as a result of cumulative implementation efforts by regulators throughout the world, significant and substantial progress has been made in the world’s primary swaps trading jurisdictions to implement the G20 commitments.”). See also id. at 16 (“[The current cross-border framework for swaps regulation] shows insufficient deference to non-U.S. regulators that have adopted comparable swaps reforms for their jurisdictions and is inconsistent with the CFTC’s traditional approach of comity with competent non-U.S. regulators in futures regulation.”).


\(^8\) Statement of Chairman J. Christopher Giancarlo on Proposed Amendments to Registration and Compliance Requirements for Commodity Pool Operators and Commodity Trading Advisors (Oct. 9, 2018).
The remainder of this article provides background information on certain exemptions from registration that are currently available with respect to the operation of non-U.S. commodity pools, describes the aspects of the Proposal that relate to these exemptions and outlines some of the concerns of practitioners regarding the Proposal, as expressed in comment letters submitted to the CFTC.

**Current State of Play – Rule 3.10(c)(3)(i) and Advisory 18-96**

**CFTC Rule 3.10(c)(3)(i)**

Under Rule 3.10(c)(3)(i), a non-U.S. person acting as a commodity pool operator in connection with any commodity interest transaction executed bilaterally or on or subject to the rules of a U.S. contract market or swap execution facility (“SEF”) only on behalf of non-U.S. persons is not required to register as a CPO, provided that any such commodity interest transaction is submitted for clearing through a registered futures commission merchant (“FCM”).\(^9\) Originally drafted to provide an exemption only for non-U.S. FCMs, but subsequently expanded to include other intermediaries, including CPOs, Rule 3.10(c)(3)(i) effectively permits non-U.S. domiciled CPOs to avoid registration in such capacity with respect to their wholly non-U.S. pools that are not offered to U.S. persons.

In general, Rule 3.10(c)(3)(i) illustrates the CFTC’s deference to home country regulators with respect to the activities of non-U.S. CPOs that have no nexus to the United States other than that they are engaging (on behalf of their non-U.S. customers) in futures, options and swap transactions on U.S. contract markets and SEFs or with U.S. counterparties.\(^10\) Notably, when Rule 3.10(c) was amended to provide for this exemption, the CFTC stated that it was not intending “to extend the scope of its regulations with respect to foreign brokers or other foreign intermediaries.”\(^11\)

**CFTC Advisory No. 18-96**

Published in April 1996, CFTC Advisory No. 18-96 ("Advisory 18-96") instituted a standardized mechanism for registered CPOs of non-U.S. investment vehicles to claim relief from many of the requirements otherwise applicable to registered CPOs. Prior to Advisory 18-96, CFTC staff provided similar relief on a case-by-case basis. Currently, upon the filing of a self-executing notice, the CPO of an Advisory 18-96 pool is exempt from all of the disclosure and many of the reporting and recordkeeping obligations that otherwise would apply to such CPO.\(^12\) Importantly,

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\(^9\) See also CFTC Staff Letter 16-08, [2015-2016 Transfer Binder] Comm. Fut. L. Rep ¶ 33,639 (Feb. 12, 2016), which provides a no-action position with respect to swaps not subject to a clearing requirement.

\(^10\) For example, in 2007, in codifying past CFTC and staff relief for FCMs in the form of Rule 3.10(c), the CFTC reiterated its policy of not seeking to regulate the activities of non-U.S. intermediaries trading on behalf of their non-U.S. customers. See 72 Fed. Reg. 15637 (April 2, 2007).


\(^12\) Advisory 18-96 also permits qualifying, registered onshore CPOs to claim certain exemptive relief from the books and records location requirement with respect to their offshore pools.
although not specified in the text, Advisory 18-96 was understood to be providing relief to *U.S. domiciled* CPOs.

Advisory 18-96 includes several requirements with respect to the qualifying pool. The pool must (i) be organized and operated outside of the United States; (ii) not hold meetings or conduct administrative activities within the United States; (iii) have no shareholder or other participant that is, or will be, a United States person as defined in CFTC Rule 4.7; and (iv) not receive, hold or invest any capital directly or indirectly contributed from sources within the United States. In addition, marketing activities with respect to the pool must avoid solicitation of U.S. persons.

Like Rule 3.10(c)(3)(i), Advisory 18-96 generally manifests the position articulated over the years by the CFTC of focusing the CFTC’s regulatory program on protecting U.S. customers and leaving the protection of non-U.S. customers to their respective home country regulators.

**The Proposal and Industry Concerns**

*Summary of Proposed Rule 4.13(a)(4)*

As part of the Proposal, the CFTC has proposed to codify Advisory 18-96 as a new Rule 4.13(a)(4), which would provide an exemption from registration for CPOs that solicit and/or accept funds solely from non-U.S. persons for participation in an offshore commodity pool, subject to the satisfaction of certain requirements. The requirements of proposed Rule 4.13(a)(4) are largely consistent with the requirements of Advisory 18-96, described above. In addition, like Advisory 18-96, proposed Rule 4.13(a)(4) would require a qualifying CPO to file a notice claiming the exemption. As is the case with Advisory 18-96 and the currently existing Rule 4.13 exemptions, proposed Rule 4.13(a)(4) would be available on a pool-by-pool basis.

*Industry Concerns*

Market participants and practitioners generally have understood the CFTC’s long-standing practice to be that a non-U.S. domiciled CPO relying on the exemption in Rule 3.10(c)(3)(i) with respect to its qualifying offshore pools is not required to file a notice of exemption with respect to such offshore pools, including in cases in which it has registered or filed a notice of exemption with respect to one or more other pools for which it acts as CPO and that are offered to U.S. persons. Market participants and practitioners understood this practice to be based on principles of international comity and the preservation of CFTC resources. To date, the CFTC has not addressed specifically whether a non-U.S. domiciled CPO may rely on Rule 3.10(c)(3)(i) for its completely offshore commodity pools, while concurrently relying on other exemptions or in a registered capacity for pools offered to U.S. persons; however, there does not appear to be any clear policy reason for not permitting such reliance.\(^\text{13}\)

\(^{13}\) In this regard, it is also helpful to remember that a U.S. domiciled CPO is permitted by Rule 4.13(e)(2) to operate qualifying pools pursuant to the exemption provided in Rule 4.13(a)(3) – in other words, as if it were not registered – while simultaneously operating Rule 4.7 or full Part 4 pools. Similarly, a CTA is permitted to advise accounts both as a registered CTA (whether under Rule 4.7 or full Part 4) and as an exempt CTA by virtue of Rule 4.14(c).
Certain language in the Proposal has raised the question, however, of whether the CFTC or its staff still adheres to this long-standing position. Based on a plausible reading of the Proposal, a non-U.S. domiciled CPO could potentially be required, as a result of the codification of Advisory 18-96, to forego reliance on Rule 3.10(c)(3)(i) with respect to its qualifying non-U.S. pools under certain circumstances, notwithstanding that such pools continue to have no discernible nexus to the United States. More specifically, the Proposal could be interpreted to require a CPO that currently relies on Rule 3.10(c)(3)(i) with respect to its non-U.S. pools (that are not offered to U.S. persons) to file a notice of exemption under proposed Rule 4.13(a)(4) with respect to all of its non-U.S. pools within 30 days of the date on which such CPO registers with the CFTC or files a notice of exemption under Rule 4.13 with respect to one or more other pools that are operated in the U.S. and/or offered to U.S. persons. The Proposal does not, however, expressly state that this is the case.

In light of this potential ambiguity, commenters have sought clarification from the CFTC regarding this aspect of the Proposal. For example, the Willkie Farr Letter requested that the CFTC confirm that a non-U.S. domiciled CPO may continue to conduct the operations of its completely non-U.S. vehicles in the manner prescribed by the relevant home country regulator in reliance on Rule 3.10(c)(3)(i), without having instead to rely with respect to such non-U.S. vehicles on the exemption provided under proposed Rule 4.13(a)(4), even in cases where such non-U.S. domiciled CPO has registered or filed a notice of exemption with respect to one or more other pools that are offered to U.S. persons. Consistent with the understanding of long-time practitioners, several commenters requested similar confirmation that the non-U.S. activities of a non-U.S. domiciled CPO will continue to remain out of scope and not trigger any filing obligation.

It would be helpful for the CFTC to provide clarity on this point for the following reasons, among others. First, a CPO that brings itself within the scope of the Commodity Exchange Act by offering a pool to a U.S. person could have many other non-U.S. investment vehicles offered only to non-U.S. persons. The rules to which these other pools are subject may or may not align neatly with CFTC rules notwithstanding that they may offer similar investor protections. As noted above,

Thus, Rules 4.13(e) and 4.14(c) make clear that CPOs and CTAs are permitted to act concurrently in both registered and unregistered capacities. Also of significance is the fact that Rule 4.14(a)(10) permits a non-U.S. CTA to count only its U.S. resident clients for purposes of determining its eligibility to rely on the CTA registration exemption in Commodity Exchange Act Section 4m(1).

14 See, e.g., 83 Fed. Reg. at 52921 (expressing the view that, under Rule 3.10(c)(3)(i), “an offshore CPO that wished to operate pools offered to U.S. persons would be required to choose between the potentially more costly options of having such pools operated by an affiliate registered with the Commission or otherwise eligible for other relief, operating all pools (regardless of location) consistent with another registration exemption, or registering as a CPO and listing all operated pools with the Commission”).

15 Question 4 of the Proposal refers to a CPO “transitioning from reliance upon § 3.10(c)(3)(i) to the 18-96 exemption.” However, the intent of this statement is not immediately apparent.

there is a concern that the codification of Advisory 18-96 could inadvertently result in non-U.S. domiciled CPOs being precluded from relying on Rule 3.10(c)(3)(i) with respect to their non-U.S. pools. The unavailability of Rule 3.10(c)(3)(i) could constitute a serious burden for such CPOs, which to date have structured their businesses around that exemption.

Second, requiring a non-U.S. CPO that operates even a single pool that is offered to U.S. persons to either file a notice of exemption under proposed Rule 4.13(a)(4) for all of its non-U.S. pools that are not offered to U.S. persons or find another available exemption, other than Rule 3.10(c)(3)(i), would appear to constitute a significant expansion of the CFTC’s jurisdiction. Such jurisdicational expansion would run counter to the CFTC’s expressed interest in preserving its resources for the protection of U.S. customers, while practicing deference to non-U.S. regulators when circumstances warrant. While the CFTC clearly has an interest in regulating the activities of non-U.S. CPOs with respect to the operation of pools offered to U.S. investors, it is less clear that the CFTC has a strong regulatory interest in exercising jurisdiction over such CPOs’ wholly non-U.S. activities.17

Insisting on a filing for all non-U.S. pools operated by a non-U.S. CPO that chooses to also offer pools to U.S. persons may impact the willingness of non-U.S. financial regulators to cooperate with the CFTC on cross-border initiatives.18 It could also potentially expose U.S.-based CPOs to foreign regulation with respect to their wholly domestic activities, if such non-U.S. regulators take action that mirrors that of the CFTC in interpreting the scope of their respective jurisdictions.

Conclusion

It remains to be seen how the CFTC will respond to comments on the Proposal, including those relating to the interaction of proposed Rule 4.13(a)(4) and Rule 3.10(c)(3)(i). Nonetheless, for the reasons articulated above, it is important for the CFTC to provide some degree of clarity so that market participants are not faced with legal uncertainty. As noted at the outset of this article, the regulatory landscape has become increasingly complex since the financial crisis and the enactment of Dodd-Frank, particularly in the cross-border context. Project KISS and the regulatory initiatives that are underway as a result of Project KISS, including the Proposal, present a valuable opportunity for the CFTC to continue to consider how to best allocate responsibility for the oversight of markets and market participants in this increasingly complex landscape, and to work together with other financial regulators to create appropriate and effective regulatory borders.

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17 As the CFTC pointed out in the Proposal, the fact that Rule 4.20(c) prohibits a CPO from commingling the property of any commodity pool that it operates, or that it intends to operate, with the property of any other person “limits the potential for trading activity or losses experienced in exempt offshore pools to negatively impact U.S. customers invested in pools for which a CPO is so registered.” 83 Fed. Reg. at 52904.

18 Cf. Swaps White Paper at 17 (noting that “[t]he CFTC arguably instigated a rift in cross-border swaps cooperation with non-U.S. jurisdictions, particularly Europe, with the CFTC Cross-Border Guidance by imposing CFTC transaction rules on swaps traded by U.S. persons, even in jurisdictions committed to implementing the G20 swaps reforms.”).
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