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Too Big to Fail U.S. Banks' Regulatory Alchemy: Converting an Obscure Agency Footnote into an "At Will" Nullification of Dodd-Frank's Regulation of the Multi-Trillion Dollar Financial Swaps Market

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Abstract

The multi-trillion dollar market for, what was at that time wholly unregulated, over-the-counter derivatives ("swaps") is widely viewed as a principal cause of the 2008 worldwide financial meltdown. The Dodd-Frank Act, signed into law on July 21, 2010, was expressly considered by Congress as a remedy for the deregulatory problems, in that market, that led to the crash. The legislation required the swaps market, subject to U.S. regulation, to comply with a host of business conduct and anti-competitive protections, including that the swaps market be fully transparent to U.S. financial regulators, collateralized, and capitalized. The statute also expressly provides that it would cover foreign subsidiaries of big U.S. financial institutions if their swaps trading could adversely impact the U.S. economy or represent an attempt to "evade" Dodd-Frank.

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In July 2013, the CFTC promulgated an 80 page, triple columned, and single-spaced "guidance" implementing Dodd-Frank's extraterritorial reach, *i.e.,* that manner in which Dodd-Frank would apply to swaps transactions executed outside the United States. The key point of that guidance was that "guaranteed" foreign subsidiaries of U.S. bank holding company swaps dealers were subject to all of Dodd-Frank's swaps regulations wherever in the world those subsidiaries' swaps were executed. At that time, the standardized industry swaps agreement contemplated that*, inter alia,* U.S. swaps dealers foreign subsidiaries would be "guaranteed" by their corporate parent, as was true since 1992.

In August 2013, without notifying the CFTC, the principal swaps dealer trade association privately circulated to its member's standard contractual language that would, for the first time, "deguarantee" foreign subsidiaries. By relying only on the obscure footnote 563 of the CFTC guidance's 662 footnotes, the trade association assured its swaps dealer members that the newly deguaranteed foreign subsidiaries could (if they so choose) no longer be subject to Dodd-Frank.

As a result, it has been reported (and also has been understood by many experts within the swaps industry) that a substantial portion of the U.S. swaps market has shifted from the large U.S. bank holding companies swaps dealers and their U.S. affiliates to their newly deguaranteed "foreign" subsidiaries. The CFTC also soon discovered that these huge U.S. bank holding company swaps dealers, through their foreign subsidiaries, were "arranging, negotiating, and executing" these swaps *in the United States with U.S. bank personnel* and, only *after* execution in the U.S., were these swaps formally "assigned" to the U.S. banks' newly "deguaranteed" foreign subsidiaries with the accompanying claim that these swaps, even though executed in the U.S., were not covered by Dodd-Frank.

In October 2016, the CFTC proposed a rule that would have closed these loopholes completely. However, the proposed rule was not finalized prior to the inauguration of President Trump. All indications are that it will never be finalized during a Trump Administration.

Thus, as the tenth anniversary of the Lehman failure approaches, there is an understanding among many market regulators and swaps trading experts that large portions of the swaps market have moved from U.S. bank holding company swaps dealers to their newly deguaranteed foreign affiliates. However, what has not moved abroad is the very real obligation of the lender of last resort to rescue these U.S. swaps dealer bank holding companies if they fail because of poorly regulated swaps in their deguaranteed foreign subsidiaries, *i.e*., the U.S. taxpayer.

While relief is unlikely to be forthcoming from either the Trump Administration or a Republican-controlled Congress, some other means will have to be found to avert another multitrillion dollar bank bailout and/or financial calamity caused by poorly regulated swaps on the books of big U.S. banks. This paper notes that the relevant statutory framework affords state attorneys general and state financial regulators the right to bring so-called "*parens patriae*" actions in federal district court to enforce, *inter alia*, Dodd-Frank on behalf of a state's citizens. That kind of litigation to enforce the statute's extraterritorial provisions is now badly needed.

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I. Summary and Introduction.

It is now accepted wisdom, indeed, it is embedded in the popular culture,[2] that it was the non-transparent, undercapitalized, and wholly unregulated over-the-counter ("OTC") swaps/ derivatives ("swaps") market that lit the fuse that exploded the world economy in the fall of 2008.[3]

Because tens of trillions of dollars of notional value embedded in these swaps were*, inter alia*, pegged to the economic performance of an overheated and highly inflated housing market, the sudden collapse of that market triggered huge unfunded payment obligations under credit default swaps ("CDS") and so-called "naked"[4] CDS that were forms of insurance guaranteeing the full value and sustainability of the subprime (and then later the prime) residential mortgage market.

The defaulting and near defaulting CDS and naked CDS "insurer" swaps counterparties, substantially composed of big banks, their affiliates, some hedge funds, and insurers, were also counterparties to many other interconnected swaps in this almost six hundred trillion dollar notional value worldwide market, including, *inter alia,* interest rate, currency, foreign exchange, and commodity swaps.[5]

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[2] *See* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 200–26 (2011); *see also* THE BIG SHORT (Paramount Pictures 2015) (winning the academy award for Best Adapted Screenplay, the film achieved critical acclaim for its effective translation of complex financial instruments to the big screen); INSIDE JOB (Sony Pictures Classics (2010)) (winning the 2010 Academy Award for Best Documentary Feature, *Inside Job* was also screened at the 2010 Cannes Film Festival); see also Sridhar Natarajan, *Pope Calls Derivatives Market a 'Ticking Time Bomb'*, Bloomberg (May 5, 2018), https://www.bloomberg.com/news/articles/2018-05-17/pope-goes-off-on-cds-market-calls-derivatives-ticking-time-bomb.

[3] *See* Ben Moshinsky, *Stiglitz says Banks Should Be Banned from CDS Trading*, BLOOMBERG (Oct. 12, 2009), http://jessescrossroadscafe.blogspot.com/2009/10/stiglitz-banks-must-be-restrained.html; Paul Krugman, *Looters in Loafers*, N.Y. TIMES (Apr. 18, 2010), http://www.nytimes.com/2010/04/19/opinion/19krugman.html?dbk; Alan S. Blinder, *The Two Issues to Watch on Financial Reform — We Need an Independent Consumer Watchdog and Strong Derivatives Regulation. Industry Lobbyists are Trying to Water Them Down*, WALL ST. J. (Apr. 22, 2010), http://online.wsj.com/article/SB10001424052748704133804575197852294753766.html; Henry T. C. Hu, *"Empty Creditors" and the Crisis*, WALL ST. J. (Apr. 10, 2009), https://www.wsj.com/articles/SB123933166470307811.

[4] For a full explanation of "naked" CDS, *see infra* notes 172-174 and accompanying text.

[5] *See infra* notes 163-171 and accompanying text for the many dozens of authorities making clear that defaults, or threatened defaults, in the swaps market were the principal cause of the 2008 meltdown. Included therein is an assessment of a competing theory about the cause of the meltdown, *i.e.*, the so-called "run on repos," which is shown to be derivative of the threatened swaps meltdown and cannot fairly be said to be the principal cause of the meltdown.

Defaults on any significant portion of these swaps would have affected the entirety of the swaps markets and upended the world economy with cascading multi-trillion dollar short-falls, threatening to leave insurmountable financial holes in the balance sheets of, *inter alia*, banks and other financial institutions, corporations, non-profits, and governments worldwide. The primary "solution" to stave off this worldwide calamity was principally to have United States ("U.S.") taxpayers saddled with trillions of dollars of bailouts for these real and threat-ened huge capital deficits that would otherwise have led to a worldwide Second Great Depres-sion.[6]

As it was, the world experienced a devastating Great Recession, which "was the most severe economic downturn and longest-persisting recession since the Great Depression."[7] In 2008-2009 in the United States alone, 8.4 million jobs were lost, constituting 6.1% of all payroll employment.[8] While the U.S. unemployment rate stood at 5% in December 2007, it topped out at 10% by October 2009.[9] U.S. housing prices fell on average of about 30% from mid-2006 to mid-2009.[10] The U.S. net worth of household and nonprofit organizations fell from $69 trillion in 2007 to a low of $55 trillion in 2009. Real gross U.S. domestic product fell 4.3 percent in the fourth quarter of 2007 to its low in the second quarter of 2009, "the largest decline in the post-war era [.]"[11]

In a direct answer to this economic calamity, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed into law on July 21, 2010.[12]

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6 *See* Moshinsky, *supra* note 2; Krugman, *supra* note 2; Blinder, *supra* note 2; Hu, *supra* note 2.

7 Andrew Fieldhouse, *5 Years After the Great Recession, Our Economy Still Far From Recovered*, HUFF. POST (June 26, 2014), http://www.huffingtonpost.com/andrew-fieldhouse/five-years-after-the-grea_b_5530597.html; *See infra* notes 33, 171 and accompanying text showing that theories about the "run on repos" were the result of defaults, and threatened defaults, on the worldwide swaps market and thus were not the principal cause of the financial meltdown.

8 *The Great Recession*, STATE OF WORKING AMERICA, http://stateofworkingamerica.org/great-recession/ (last visited Apr. 12, 2017).

9 Robert Rich, *The Great Recession: December 2007-June 2009*, FED. RESERVE (Nov. 22, 2013), https://www.federalreservehistory.org/essays/great_recession_of_200709.

10 *Id.*

11 *Id.*

12 Helene Cooper, *Obama Signs Overhaul of Financial System*, N.Y. TIMES (July 12, 2010), http://www.nytimes.com/2010/07/22/business/22regulate.html?_r=0.

A principal purpose of that statute was to assure U.S. taxpayers (themselves battered, and many still so, by the resulting financial storms) that they would never again be called upon to bail out, *inter alia*, the very biggest bank holding companies.[13] Among the many financial reforms prescribed, the most important gave United States financial regulators the tools to prevent another meltdown of the previously unregulated, several hundred trillion dollar notional value, swaps markets.[14] It did so by requiring, *inter alia*, that the swaps market be fully transparent to federal regulators, properly collateralized and capitalized, and subject to pro-competiveness principles and business conduct standards.[15]

The chief U.S. swaps regulator established by Dodd-Frank is the U.S. Commodity Futures Trading Commission ("CFTC"), which oversees 95% of the U.S. swaps market.[16] The CFTC, in the three years after the passage of Dodd-Frank, put in place over fifty substantive rules implementing the Dodd-Frank swaps regulatory regimen.[17]

During the closing stages of the Dodd-Frank legislative process, key drafters of that statute responded directly and immediately to what was then a three-day-old United States Supreme Court case, *Morrison v. National Australia Bank, Ltd.,*[18] which made clear that if a statute is to have extraterritorial effect, Congress must state so clearly.[19] As a result, the lead Senate drafters of Dodd-Frank, on June 24, 2010, added an extraterritorial provision to that legislation, which became section 722(i) of the act. That section provides that Dodd-Frank's regulation of

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13 *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010) (describing the law's purpose as "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes").

14 *See infra* notes 299-323 and accompanying text.

15 *Id.*

16 *Id.* Established in 1974, the CFTC is an independent regulatory agency that is responsible for the regulation of all the commodity futures and swaps markets, except the roughly 5% of the swaps market that constitutes equity-based swaps that are regulated by the Securities Exchange Commission ("SEC"). *Mission & Responsibilities*, U.S. CFTC, http://www.cftc.gov/About/MissionResponsibilities/index.htm (last visited Apr. 10, 2017).

17 *See infra* notes 337-339 and accompanying text.

18 561 U.S. 247 (2010).

19 *See infra* notes 330-36 and accompanying text.

swaps must apply to swaps executed outside the U.S. if that trading has "a direct and significant connection with activities in, or effect on, commerce of the United States;" *or* if those swaps, by their extraterritorial execution, "contravene such rules and regulation as the [CFTC] may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of [Dodd-Frank]."[20]

In July 2013, the CFTC promulgated its so-called "guidance," implementing Dodd-Frank's extraterritorial provision.[21] For purposes of this paper, the key point of that CFTC guidance was that "guaranteed" foreign subsidiaries of U.S. bank holding company swaps dealers were to be subject to all of Dodd-Frank's swaps regulations wherever in the world the subsidiaries' swaps were executed.[22] At that time, and for more than two decades prior to that time, the standard industry-wide swaps documentation drafted by the International Swaps Derivatives Association ("ISDA") (which swaps dealers are required to use) contemplated that subsidiaries of its member swap dealers would be "guaranteed" by the parent.[23]

About one month after promulgation of the July 2013 extraterritorial guidance, ISDA, relying on parts of footnote 563 within that document's 80 pages (triple columned, single spaced), provided standardized model swap contract language to its members allowing them to "deguarantee" their foreign subsidiaries by checking a "deguarantee" box in a written declaration, thereby proclaiming that those newly "deguaranteed" foreign subsidiaries were not subject to Dodd-Frank.[24] In result, it has been reported and understood among swaps industry experts that a large portion of the U.S. swaps market shifted from the largest U.S. bank holding companies, and their U.S. affiliates, to their newly deguaranteed "foreign" affiliates, even though those swaps remained on the consolidated balance sheets of these U.S. institutions. Once attributed to the "foreign newly deguaranteed" affiliate, U.S. bank holding company

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[20] *Id*.

[21] *See infra* notes 339-40, 354-58 and accompanying text.

[22] *See infra* notes 403-05 and accompanying text.

[23] *See infra* notes 105-09 and accompanying text.

[24] *See infra* notes 403-16 and accompanying text.

swaps dealers in many important instances treated these swaps as being outside the reach of Dodd-Frank's swaps regulation.[25]

Roughly three years later, the CFTC addressed the then newly discovered fact that, *inter alia*, these huge U.S. bank holding company swaps dealers were often "arranging, negotiating, and executing" ("ANE") these purported "foreign" swaps *in* the U.S. *through* U.S personnel but then "assigning" those fully executed swaps to their newly "deguaranteed" foreign subsidiaries, asserting that these swaps were not covered by Dodd-Frank even though completed in the United States.[26]

The CFTC, at first unknowingly, and then largely unquestioningly, allowed, *inter alia*, the four largest U.S. bank holding company swaps dealers, that control 90% of the U.S. swaps market, to use the "deguarantee" and ANE tactics to evade Dodd-Frank at their discretion.[27] Those four U.S. swaps dealers are in order of swaps trading size: Citibank, JPMorgan Chase, Goldman Sachs and Bank of America.[28]

As a result, swaps fully executed in the U.S. by U.S. bank personnel could, after complete execution, be assigned to newly deguaranteed U.S. bank holding foreign subsidiaries where they could be deemed not to be regulated under Dodd-Frank. Moreover, as a result of CFTC *staff* – not Commission – action, "foreign" swaps dealers, including subsidiaries of U.S. bank holding companies, that are registered with the CFTC to do swaps dealing in the U.S., are

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[25] *See infra* notes 409-16 and accompanying text.

[26] *See infra* notes 452-53 and accompanying text.

[27] *See infra* notes 406-16, 452-53 and accompanying text. In December 2013, a CFTC staff advisory stated that the use of ANE by non-U.S. persons registered with the CFTC would subject those swaps to some, but not all, CFTC swaps regulations. BETTER MARKETS COMMENT LETTER ON CROSS BORDER APPLICATION OF REGISTRATION THRESHOLDS 8 (Dec. 19, 2016), https://www.bettermarkets.com/rulemaking/better-markets-comment-letter-cftc-cross-border-application-registration-thresholds-and. That advisory was vigorously challenged by U.S. swaps dealers and its application was so tenuous that the CFTC had to include in an October 18, 2016 proposed rule that ANE swaps were subject to CFTC jurisdiction. *Id.* This conclusion, however, only made clear that the CFTC's business conduct standards would apply to ANE trading, and further application of all other swaps regulation to ANE swaps. *Id.* at 8-9. But the general tenor of the October 18, 2016 proposed rules was that the use of ANE to evade Dodd-Frank in any way was to come to an end. Of course, as shown below, the October 18, 2016 proposed rule was never made final before the beginning of Donald Trump's Presidency, and it is unlikely during his Presidency to be made final.

[28] *See infra* notes 379 and accompanying text.

as of July 2017 indefinitely freed from key Dodd-Frank swaps regulations even if their home country has no, or inadequate, swaps regulatory protections.[29]

Each of the four big U.S. bank holding swaps dealers described above that may now, at their discretion, avoid Dodd-Frank swaps regulation, *inter alia*, through the deguarantee and ANE loopholes. Each is headquartered in the U.S. and has its principal place of business there.[30] Collectively, these four big U.S. bank holding company swaps dealers handle close to 90% of U.S. swaps trades.[31] They have all been labeled "systemically important" under Dodd-Frank by the U.S. Financial Stability Oversight Board, meaning that in another financial meltdown, they would almost certainly need to be financially bailed out by U.S. taxpayers to avoid a Second Great Depression.[32]

Of course, each of these banks benefitted from substantial U.S. taxpayer subsidies after the 2008 financial meltdown.[33] In this regard, studies have shown that the present widespread expectation within the financial sector that U.S. taxpayers will rescue these huge banks in times of economic peril has been capitalized within the stock prices of these banks to increase those prices above the level that would be present in the absence of U.S. taxpayers' expected status

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29 *See infra* notes 507-13 and accompanying text.

30 *See infra* note 341 and accompanying text. On this ground alone, there is no question that U.S. jurisdiction over these four banks can be had in almost every, if not every, U.S. federal district court in the nation. Michael Greenberger, *The Extraterritorial Provisions of the Dodd-Frank Act Protects U.S. Taxpayers from Worldwide Bailouts*, 80 UMKC L. REV. 965, 971-72 (2012). Indeed, any financial institution conducting swaps business that has a "direct and significant" connection to U.S. commerce and is doing business in the United States would be subject to U.S. federal court jurisdiction where it is doing business. *Id*.

31 *See* OFF. OF THE COMPTROLLER OF THE CURRENCY, QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES 3 (Fourth Quarter 2017), https://www.occ.gov/topics/capital-markets/financial-markets/derivatives/dq318.pdf.

32 *See infra* note 341 and accompanying text.

33 *See, e.g.*, Mike Collins, *The Big Bank Bailout*, FORBES (July 14, 2015), https://www.forbes.com/sites/mikecollins/2015/07/14/the-big-bank-bailout/#20a7755a2d83 ("The Special Inspector General for TARP summary of the bailout says that the total commitment of government is $16.8 trillion dollars with the $4.6 trillion already paid out."); John Carney, *The Size of the Bank Bailout: $29 Trillion*, CNBC (Dec. 14 2011), https://www.cnbc.com/id/45674390.

as their lenders of last resort.[34] While many U.S. taxpayers have yet to fully recover from the Great Recession,[35] these four big U.S. bank holding companies have thrived.[36]

It was not until the spring of 2014 that CFTC staff first learned about the "deguarantee" loophole sponsored by ISDA and adopted by, *inter alia*, the four big U.S. bank holding company swaps dealers.[37] It appears that it was not until 2016, that the CFTC first addressed the companion ANE loophole, which allows swaps fully executed in the U.S. by U.S. bank personnel to evade Dodd-Frank swaps regulations by later "assigning" those completed swaps to U.S. bank holding companies' newly deguaranteed "foreign" bank subsidiaries.[38]

In November 2014, the then new CFTC Chairman, Timothy Massad, first questioned the use of the deguarantee loophole to avoid Dodd-Frank.[39] By March 2015, the CFTC closed the

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[34] Edward J. Kane, *Perspectives on Banking and Banking Crises*, 6, 7 (unpublished manuscript) (on file with author), (https://www2.bc.edu/edward-kane/Perspectives%20on%20Banking%20and%20Banking%20Crises.pdf) ("In good times and in bad, being too big to fail simultaneously lowers both the cost of a firm's debt and the cost of its equity. This is because too-big-to-fail guarantees lower the risk that flows through to owners of both classes of securities. These guarantees chop off bondholders' and stockholders' losses at a specified point and direct the flow of further losses to taxpayers…. The only time AIG's stock price approached zero—and it did so twice—was when the possibility of a US government takeover fell under active discussion, so that the probability of stockholders' continued rescue was falling. As soon as this course of action was tabled, the stock price surged again because TBTF policies handed the value of the stop-loss back to AIG's stockholders."); Marc Labonte, *Systemically Important or "Too Big to Fail" Financial Institutions*, CONG. RESEARCH SERV. 6 (May 26, 2017), https://fas.org/sgp/crs/misc/R42150.pdf ("In some cases, shareholders have borne some losses through stock dilution, although their losses may have been smaller than they would have been in a bankruptcy."); IMF News, *IMF Survey: Big Banks Benefit from Government Subsidies* (Mar. 31, 2014), http://www.imf.org/en/News/Articles/2015/09/28/04/53/sopol033114a ("In its latest analysis for the Global Financial Stability Report, the IMF shows that big banks still benefit from implicit public subsidies created by the expectation that the government will support them if they are in financial trouble.").

[35] *See infra* note 367 and accompanying text; *see also, e.g.*, Lydia DePillis, *10 Years After the Recession Began, Have Americans Recovered?*, CNN MONEY (Dec. 1, 2017), http://money.cnn.com/2017/12/01/news/economy/recession-anniversary/index.html (". . . Americans still carry the scars of the recession, some of which will never heal."); Abigail Summerville, *A Decade after Great Recession, 1 in 3 Americans Still Haven't Recovered*, CNBC (July 13, 2017), https://www.cnbc.com/2017/07/13/a-decade-after-great-recession-1-in-3-americans-still-havent-recovered.html.

[36] *See e.g.*, Matt Egan, *Too-Big-To-Fail Banks Keep Getting Bigger*, CNN MONEY (Nov. 21, 2017), http://money.cnn.com/2017/11/21/investing/banks-too-big-to-fail-jpmorgan-bank-of-america/index.html; Stephen Gandel, *By Every Measure, The Big Banks are Bigger*, FORTUNE (Sept. 13, 2013), http://fortune.com/2013/09/13/by-every-measure-the-big-banks-are-bigger/.

[37] *See infra* note 435 and accompanying text.

[38] *See infra* notes 358-59, 450-51 and accompanying text; moreover, a recent ruling of the U.S. Court of Appeals for the Second Circuit strongly suggests that the execution of the swap in the United States alone means that the transaction is *not* extraterritorial, but a "domestic transaction" and therefore completely subject to Dodd-Frank even if the swaps was later "assigned" to a foreign subsidiary. *Choi* v. *Tower Research Capital LLC*, No. 17-648 (2d Cir. March 28, 2018).

[39] *See infra* note 436 and accompanying text.

deguarantee loophole for a portion of only one of the thirteen types of Dodd-Frank swaps regulations*, i.e.*, swaps regulation dealing specifically with applying Dodd-Frank swaps margin requirements to uncleared swaps.[40]

However, in October 2016, the CFTC proposed a rule and interpretations that, upon becoming final, would have ended *completely* the deguarantee loophole for *all* of its swaps regulations.[41] At that time, the CFTC also first noted the existence of the ANE loophole and then attempted to end it completely in the proposed rule.[42] However, the October 2016 proposals were never finalized by the CFTC before the inauguration of President Trump, and all indications are that the proposals will never be finalized during a Trump Administration.[43] In sum, the deguarantee and ANE loopholes will remain in effect at the very least for years to come.[44]

Because of the lack of transparency concerning swaps trading before Dodd-Frank went into effect and because so much of the trading was done through deguaranteed foreign subsidiaries of U.S. swaps dealers after Dodd-Frank's passage, a fully accurate accounting of the extent to which swaps have moved abroad from the U.S. is quite difficult. However, many market experts noticed a very significant movement of swaps abroad after the deguarantee loophole was created. Moreover, a highly cited study by Reuter's calculated that up to 95% of certain lines of swaps trading had moved outside the U.S. under the deguarantee loophole and thus were considered not to be subject to Dodd-Frank swaps regulations.[45] However, while the trading has likely moved abroad in great numbers, those trades would still be reflected in the consolidated balance sheets of, *inter alia*, the four big U.S. bank holding company swaps dealers. Moreover, those trades have only "moved" from the U.S. parent swaps dealers and their U.S. affiliates to

40 *See infra* notes 437-44 and accompanying text.

41 *See infra* notes 445-49 and accompanying text.

42 *See infra* notes 450-57 and accompanying text.

43 *See infra* note 361-64 and accompanying text.

44 *See also infra* notes 507-13 and accompanying text for a discussion of yet a further unlimited CFTC complete exemption from Dodd-Frank swaps rules authored—*not by the CFTC itself*—but the CFTC staff for foreign swaps traders *registered to do swaps trading by the CFTC* with non-U.S. persons. This exemption is afforded as a matter of "international comity" so as not to conflict with foreign swaps law *even when there is no applicable foreign swaps law to be applied*.

45 *See infra* notes 349-56, 416 and accompanying text.

their newly "deguaranteed" foreign subsidiaries. What has *not* moved abroad is the obligation of the lender of last resort to these four big U.S. banks: *i.e.*, the U.S. taxpayer, who is understood throughout the financial world to be subject to a call for funds to bail out these banks should a new crisis threaten worldwide cascading swaps defaults that, if not stopped, will lead to financial Armageddon.[46]

To understand the significance of, *inter alia*, the deguarantee and ANE loopholes, it is first important to understand what, in fact, swaps are and how unregulated swaps have caused many serious financial dysfunctions, and then, ultimately in September 2008, the full destabilization of the world economy. That information is provided in the next section of this paper.

This background is important because the swaps market is widely recognized by economists, financial regulators, members of Congress, and other financial market experts to be the most poorly understood of all financial markets.[47] As Senator Chris Dodd said, after passage of Dodd-Frank:

> "One of the problems that I had as a member of Congress on this issue, is financial literacy is not [just] a general problem with the public, it's a general problem with too many people, including my colleagues . . . It is not well understood . . . . Too often, in the banking [area] . . . when your Bill is on the floor of the Senate, the question would be not [be] 'explain to me the derivatives section,' . . . the question is 'is [the derivatives section] okay' . . . and that was basically the only question you'd get."[48]

Because swaps markets are so poorly understood, the import of these extraterritorial loopholes from Dodd-Frank's regulation of these markets is, similarly, misunderstood. Ending

[46] *See* IMF News, *IMF Survey: Big Banks Benefit from Government Subsidies* (Mar. 31, 2014), http://www.imf.org/en/News/Articles/2015/09/28/04/53/sopol033114a.

[47] *See* Discover GW, *Sen. Chris Dodd: Cohen Lecture at The Shape of Things to Come*, YouTube (Jan. 17, 2011); *see also* Brent J. Fields, *Better Markets*, U.S. Sec. and Exchange Commission (Oct. 26, 2015), https://www.sec.gov/comments/s7-14-15/s71415-3.pdf (describing the swaps market, Secretary of the U.S. Securities and Exchange Commission, Brent Fields states, "[D]erivatives are complex and poorly understood by even sophisticated market participants.").

[48] *Id.*

these loopholes and a return to protecting the U.S. taxpayer against multi-trillion dollar bank bailouts are made that much more difficult by this lack of knowledge.[49]

Moreover, with all the attention being given to President Trump's claims that Dodd-Frank will be "rolled back," there is a surprising reticence on the part of the big Wall Street banks and the Trump Administration about rolling back specifically Dodd-Frank *swaps regulatory provisions.* [50]

One could rationally conclude that, with the benefit of the "deguarantee and ANE" loopholes to evade application of Dodd-Frank swaps rules, there is no need for the U.S. banks to "roll back" U.S. Dodd-Frank swaps rules by new legislation.[51] Moreover, there are recent important Congressional statements by even outspoken supporters of weakening Dodd-Frank showing a strong political distaste for Congressionally enacted deregulation that helps the very biggest U.S. bank holding companies[52]; and any legislation advanced to repeal Dodd-Frank swaps regulation for those huge banks might also be the target of a legislative rider to reinstate a "modern day" Glass-Steagall in a format which would cause these U.S. swaps dealer banks to separate some or all of their commercial banking efforts with federally-insured commercial deposits to separate bank structures, thereby stopping completely or cutting substantially their speculative swaps trading.[53] Such trading (or large portions of such trading) could then only be done by wholly separated investment banks – and thus JPMorgan Chase, Citibank, and Bank of

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49 *See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, A USER'S GUIDE FOR THE BANK HOLDING COMPANY PERFORMANCE REPORT (Mar. 2014), https://www.federalreserve.gov/boarddocs/supmanual/bhcpr/Usersguide14/0314.pdf (explaining the meaning of data contained within quarterly reports of Financial Holding Companies by Peer Group); *see also* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, BANK HOLDING COMPANY PERFORMANCE REPORT, PEER GROUP DATA, Peer Group 01, at 10 (Sept. 2016), https://www.ffiec.gov/nicpubweb/content/BHCPRRPT/REPORTS/BHCPR_PEER/Sept2016/PeerGroup_1_September2016.pdf; Silla Bush, *Wall Street Faces New U.S. Scrutiny of Derivatives Tactic*, BLOOMBERG (July, 30 2014), https://www.bloomberg.com/news/articles/2014-07-30/wall-street-facing-new-u-s-scrutiny-of-derivatives-rule-tactic (describing a CFTC staff letter, discussing how five banks "control 95 percent of cash and derivatives trading for U.S. bank holding companies as of March 31, according to the Office of Comptroller of the Currency").

50 *See infra* notes 366-401 and accompanying text.

51 *See infra* note 401 and accompanying text.

52 *See infra* notes 370-91 and accompanying text.

53 *See infra* notes 393-401 and accompanying text.

America at least would likely have to either completely or substantially abandon swaps trading.[54]

The deguarantee and ANE loopholes, which originated in the Obama Administration's CFTC, are certainly not likely to be closed in the Trump Administration. Relief is also unlikely to be found in a Republican-controlled Congress. However, the relevant swaps statutory framework now affords state attorneys general and state financial regulators the right to bring so-called "parens patriae" actions in federal district courts to enforce, *inter alia*, Dodd-Frank on behalf of a state's citizens. States attorneys general, for example, have aggressively litigated in federal district courts to enjoin U.S. banks' financial irregularities.[55] However, little (if anything) has been done by the states in the swaps arena. This is because there is so little knowledge of swaps even in the otherwise highly capable offices of state attorneys general and state financial regulators.

It is the hope that this paper may remedy that lack in understanding of a market that has brought, and, if not properly regulated, will once again bring, the most severe adverse economic consequences imaginable worldwide. A history of the market and its traditional poor regulation begins in the next section of this paper.

Finally, as is also shown in detail below,[56] there are well publicized pronouncements, most prominently by the new Fed chair, Jerome Powell,[57] that the U.S. economy is booming with low unemployment and benefits to be derived from the touted stimulus effect of the recent passage of the Tax Cuts and Jobs Act of 2018; and it is not now foreseeable that the "too big to fail" U.S. banks could face the insolvency and threatened insolvency that occurred in 2008. It is this sense of euphoria that undergirds arguments for Dodd-Frank deregulation.

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54 *See infra* notes 398-401 and accompanying text.

55 *See infra* notes 583-84 and accompanying text.

56 *See infra* notes 268-71 and accompanying text.

57 *Id.*

However, there is an equally persuasive, if not as well publicized, counter assessment by distinguished financial observers that there are too many similarities between today's economy and the seemingly strong economy leading into the 2008 meltdown.[58] The country is now again awash in defaults on consumer indebtedness in the multi-trillion dollar credit card, student loan, and auto loan markets.[59] Even worse, the indebtedness in these markets is accompanied by the very same financial engineering infrastructure, including swaps, which collapsed in the 2008 mortgage crisis.[60] These observers have persuasively argued that the rising defaults and the likely resulting failure of the accompanying financial engineering structures could very well lead to the next financial meltdown and a new call for U.S. taxpayer bailouts.[61] Therefore, this is certainly not the time to gamble with the world economy by creating massive loopholes in the application of Dodd-Frank swaps regulation.

II. The Troubled History of the Swaps Market and its Poor Regulation

Beginning in 1865, farmers and grain merchants organized in Chicago to hedge price risk in corn, wheat, and other grains in what are thought to be the earliest sustained derivatives transactions in this country.[62] These kinds of derivatives have been historically referred to as "futures contracts."[63]

Since their creation, these futures contracts were recognized as being subject to price distortion, *i.e.*, rather than providing the intended successful commercial hedging, they can cause hedging entities and their consumers to pay excessive or (in the case of producers) unduly low, unnecessary and unexpected spot (or market) prices. This price distortion happens

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58 *See infra* notes 272-98 and accompanying text.

59 *Id.* See also Steven Pearlstein, *Beware the 'mother of all credit bubbles'*, The Washington Post (Jun. 8, 2018), https://www.washingtonpost.com/business/economy/beware-the-mother-of-all-credit-bubbles/2018/06/08/940f467c-69af-11e8-9e38-24e693b38637_story.html?noredirect=on&utm_term=.a007d7c21fb3, (warning that 2018 is reminiscent of the run up to the 2008 crash and that that next meltdown will concern corporate debt now reaching "record levels" aggravated by "another round of financial engineering that converts equity into debt.").

60 *Id.*

61 *Id.*

62 Jonathan Ira Levy, *Contemplating Delivery: Futures Trading and the Problem of Commodity Exchange in the United States, 1875-1905*, 111 AM. HIST. REV. 307, 307–09 (2006).

63 NICK BATTLEY, AN INTRODUCTION TO COMMODITY FUTURES AND OPTIONS 17–18 (2d ed. 1995).

through excessive speculation, fraud, and/or manipulation within those markets.[64] As one disgruntled farmer told the House Agriculture Committee in 1892:

> "[T]he man who managed or sold or owned those immense wheat fields has not as much to say with the regard to the price of the wheat than some young fellow *[i.e.*, futures trader] who stands howling around the Chicago wheat pit [*i.e.,* futures exchange] could actually sell in a day."[65]

A. <u>The Origins and Purposes of the Commodity Exchange Act's Regulation of Derivatives</u>

Because excessively low farm prices wreaked financial havoc on America's agriculture sector shortly before and during the Great Depression, President Franklin D. Roosevelt recommended to Congress, as one of his earliest financial market reform proposals, legislation that became the Commodity Exchange Act of 1936 ("CEA").[66] When introducing this legislation in 1934, President Roosevelt said: "[I]t should be our national policy to restrict, as far as possible, the use of these [futures] exchanges for purely speculative operations."[67] Accordingly, the 1935 Report of House Agriculture Committee, which led to the 1936 Act, stated:

> "The fundamental purpose of the measure [*i.e.*, the CEA] is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves."[68]

Thus, the CEA, as amended, required that all futures contracts be traded on a regulated exchange providing full transparency to regulators of trading behavior and to the public of the formation of futures prices.[69] The exchange-trading requirement of the CEA was so central to

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[64] *See* Levy, *supra* note 61, at 310.

[65] *Id*. at 307 (quoting *Fictitious Dealings in Agricultural Products: Hearing on H.R. 392, 2699, and 3870, Before H. Comm. on Agric.*, 52d Cong. (1892)).

[66] Franklin D. Roosevelt, *Public Papers and Addresses of Franklin D. Roosevelt*, 3 PUB. PAPERS 81 (1938); *see also* 7 U.S.C. §§ 6–27 (2006) (as amended).

[67] *Id.* at 91.

[68] H.R. REP. NO. 421 at 1 (1935); Donald A. Campbell, *Trading in Futures Under the Commodity Exchange Act*, 26 GEO. WASH. L. REV. 215, 223 (1958).

[69] 7 U.S.C. § 6(a) (2009) (as amended).

that statute's effectiveness that it is still a felony to knowingly violate it, and substantial criminal penalties or civil fines may be levied upon offending traders and their employees.[70]

B. The Nature of Futures Contracts

The most prominent treatise on derivatives defines a "futures contract" as follows:

> "The traditional futures contact is an agreement between a seller and a buyer that the seller (called a short) will deliver to the buyer (called a long), at a price agreed to when the contract is first entered, and the buyer will accept and pay for, a specified quantity and grade of an identified commodity during a defined time in the future."[71]

While futures contracts were first developed for the agricultural sector, they ultimately expanded into hedging vehicles for metals and energy markets.[72] "[T]here has been a continual [further] expansion of the futures and derivatives markets [to] [f]inancial futures — on government securities, private debt issues, foreign currencies, and stock indices — an increasingly important part of the commodities world."[73]

> "Standardization of [the] terms is a key feature of publicly traded futures contracts. [Under] a futures contract, [al]most [all] customers do *not* expect to take delivery. There is an opportunity to offset the delivery [obligation], and the customer has a right to liquidate rather than take [or make] delivery."[74]

Indeed, it is very rare that delivery is executed under a futures contract.[75] (A full explanation of the hedging mechanism provided by future contracts is beyond the scope of this paper but is otherwise fully explained by sources cited in the margin.).[76] Only through the use of

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70 *Id.* § 13(b).

71 PHILLIP M. JOHNSON & THOMAS L. HAZEN, 1 DERIVATIVES REGULATION §1.02[3] at 25 (2004) [hereinafter JOHNSON & HAZEN].

72 *Id.* § 1.02[1] at 7–8.

73 *Id.* § 1.02[1] at 11.

74 *Id.* § 1.02[3] at 24–25 n.97 (internal citations omitted; emphasis added).

75 PRAKASH G. APTE, INTERNATIONAL FINANCE: A BUSINESS PERSPECTIVE 149 (2009) ("[I]n most futures markets, actual delivery takes place in less than one percent of the contracts traded.").

76 BATTLEY, *supra* note 62, at 7–11 (explaining that the basic purpose of trading out of a futures contract "is to use the futures market to prevent or minimize the effects of adverse price movements in the physical commodity" by effectively, "seek[ing] an outright profit in future [trade] to offset a potential loss in physicals"). Battley delineates this technique into two categories: a "producer hedge," which protects against the market price falling and a "consumer hedge", which protects against the market price rising. *Id.* at 8. To illustrate a producer hedge, Battley sets out the example of an oil refiner who, despite current physical market costs at $145, expects those prices to drop, so the refiner sells oil futures at $144. *Id.* at 8–9. As expected the market price drops to $140, which creates a $5 loss for the refiner on the physical market; however, the futures price also drops to $139. *Id.* To offset the $5 loss in the physical market, the refiner

highly standardized futures contracts can the necessary liquidity be developed that allows traders the much-needed ability to quickly offset delivery commitments in order to avoid unwanted (indeed, often impossible) delivery obligations but still hedge market spot prices.[77]

C. The Contours of the CEA's Exchange Trading Requirement

As would be expected of a market regulation bill that followed in the wake of the Securities Acts of 1933 and 1934, the contours of the CEA's futures exchange regulation mirrors the regulation of the equities markets, *i.e.*, futures contracts were required to be traded on publicly-transparent and fully-regulated exchanges supported by clearing mechanisms to ensure that contractual commitments would be backed by adequate collateral and capital of the futures contract counterparties and the clearinghouse.[78]

Under the CEA, regulated exchanges ensured that futures contracts were subject to: (1) public and transparent price formation based on market demand; (2) disclosure of the real trading parties in interest to federal market regulators; (3) regulation of intermediaries; *i.e*., brokers and their employees; (4) stringent rules for customer protection; (5) self-regulation by exchanges directly supervised by a federal regulator to detect unlawful trading activity; (6) prohibitions against fraud, market manipulation, and excessive speculation; and (7) enforcement of all these requirements by a federal regulator, private individuals, and the states. The latter two remedies are afforded by private rights of action for adversely-affected traders and customers; and by state *parens patriae* suits to be brought by state attorneys general and state financial regulators, respectively.[79]

"squares out his [futures] position . . . by buying . . . at $139". Thus, because when the refiner sold the futures, he received $144, and when he bought at the lower price he only paid $139, in effect the refiner nets $5 to completely offset the physical market loss. *Id.* at 9. To illustrate the consumer hedge, Battley presents the oil market example from an oil distributor's perspective, summarizing that, in this context, the consumer's fear is a rise in the physical market price, and to "minimize the effects of such a price movement, [consumers] may buy on the futures market so that, should the physical price move up thereby forcing them to pay more than they anticipated for their oil, the [corresponding] increase in the futures price will provide . . . an offsetting profit." *Id.* at 10; *see also* JOHNSON & HAZEN, *supra* note 70, at § 1.03[2] (addressing the "hedging function" and analogizing the "hedge" to an insurance policy on investment).

[77] APTE, *supra* note 74. One more recent accepted method of "avoiding delivery" is to "cash settle" the futures transaction based on the market price of the futures contract, a settlement process that has been deemed by the Commodity Futures Trading Commission ("CFTC") to be wholly permissible under the CEA; JOHNSON & HAZEN, *supra* note 70, at § 1.03[8], at 146–47.

[78] *See* JOHNSON & HAZEN, *supra* note 70, at §§ 1.02[2][E], 102[8][F], 1.05.

[79] 7 U.S.C. § 6 (2006).

As an essential part of this regulatory format, futures contracts have to be "cleared," *i.e*., a well-capitalized and regulated intermediary institution is required to stand between the counterparties of a futures contract to ensure that commitments undertaken pursuant to those contracts are adequately collateralized through the collection of margin to prevent counter-party harms from contractual defaults.[80] Any contractual default by a counterparty is guaranteed by the clearing facility, a financial commitment that serves to ensure that the clearing facility has a strong incentive to enforce strictly the collateralization of each trade, through highly disciplined daily assessments of the market prices of futures positions, as well as the immediate collection by the clearing facility of two types of margin from the counterparties: (1) the payment of initial margin upon executing and listing a futures contract and (2) the payment of variation margin when the contract price moves against a counterparty to the trade.[81]

D. The Development and Characteristics of Swaps

By the 1980s, a variant of futures contracts was developed, commonly referred to as swaps.[82] When first addressing swaps contracts, the CFTC defined them as "an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchanges rates, or prices with payment calculated by reference to a principal base (notional amount)."[83]

Similarly, ISDA, the major private, self-regulatory body of swaps dealers which must be members to have the right to trade swaps using ISDA's widely-used, copyrighted, contractual templates, defines a swap as "[a] derivative where two counterparties exchange streams of cash flows with each other. These streams of cash flows are known as the 'legs' of the swap and are calculated by reference to a notional amount."[84]

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80 *See* JOHNSON & HAZEN, *supra* note 70, at § 1.05.

81 *See id.*

82 *See id.* at § 1.02[8][A].

83 Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694, 30695 (July 21, 1989).

84 INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., DCG GLOSSARY, http://www.isda.org/c_and_a/oper_commit-dcg-glossary.html (last visited Feb. 15, 2017).

The classic example of a swap is an interest rate swap where one party to the agreement exchanges with the swaps dealer a floating interest rate obligation on an existing loan for a fixed rate obligation to the dealer.[85] Usually, the person swapping the floating rate for a fixed rate is expecting (or hedging against the future possibility that) the fixed rate will be lower than the floating rate.[86]

In other words, the underlying loan is almost never negotiated or renegotiated under the swap.[87] It is an assumed amount written into the swap, most often (but not necessarily, especially in cases of interest rate speculation) reflecting an actual outstanding loan of one of the swap's counterparties from a creditor or lender upon which, pursuant to a loan, the floating rate is to be paid.[88] Under an interest rate swap, the fixed interest rate payments paid (in lieu of an adjustable rate specified in the loan document) under the swap by the counterparty "the borrower" to the swaps dealer would also be specified in the transaction, as would the manner in which the floating rate is to be calculated.[89] Thus, rather than buying/selling a *single* future rate or price (as would be true in a traditional futures contract), there is a "swapping" of commitments, with one party buying the fixed rate and selling the floating rate (usually the non-dealer), while the other party (usually the dealer) is buying the floating rate and selling the fixed rate.[90]

In the interest rate swap scenario described above, the counterparty with a loan is "hedging" against increased interest rates to be paid as a floating rate obligation. The bank swaps dealer counterparty may be deemed to be speculating that interest rates will not in-

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85 *Id.*; *see also* SATYAJIT DAS, TRADERS, GUNS AND MONEY: KNOWNS AND UNKNOWNS IN THE DAZZLING WORLD OF DERIVATIVES (rev. ed. 2010).

86 *The Role of Derivatives in the Financial Crisis: Hearing before the Financial Crisis Inquiry Commission*, 111th Cong. 3-4 (2010) (testimony of Prof. Michael Greenberger, Univ. of Md. Carey Sch. of Law) [hereinafter Greenberger Testimony]. *See also* BATTLEY, *supra* note 62, at 5–12.

87 Greenberger Testimony, *supra* note 85.

88 *Id.*

89 *Id.*

90 *Id.*

crease, but it usually hedges that risk both by the substantial fees paid by the non-dealer counterparty to the swap dealer for the right to enter into the interest rate swap; and by the swaps dealer itself often hedging its swaps exposure through a mirror but opposite interest rate swap.

Most important, there was (and is) no bar to either or both counterparties speculating on the future price of interest rates through such a swap. That is, the counterparties are free not to hedge any existing credit exposure but instead can be "betting" on the future direction of interest rates. As a *Wall Street Journal* editor and author recently observed, in a thorough analysis of manipulation in the speculative use of interest rate swaps: "[Interest rate] swaps [are] simply another vehicle with which banks could bet on the future direction of interest rates . . . . By 2010, some $1.28 *trillion* of these interest rate swaps changed hands on a daily basis . . . ."[91]

As will be shown below, it is most often speculation in the use of swaps, *i.e.*, betting on the price direction of the index on which the swap is based, that has caused serious financial dislocations, *e.g.*, in the 2008 financial meltdown, where investors used naked "short" swaps to bet that mortgages *which they did not own* would fail, thus entitling those shorts to recover the complete amount of the actual loss on those mortgages even though they did not own them. It was the indebtedness of, *inter alia*, U.S. bank holding company swaps dealers or their affiliates to pay off those mortgage "losses" guaranteed to the shorts that punched a major hole in the world economy because, *inter alia*, the U.S. bank holding company swaps dealers, or its affiliates, operating in the pre-Dodd-Frank unregulated environment had neither sufficient capital nor collateral in reserve to fall back on to pay off the shorting counterparties; nor were these transactions cleared.

Similarly, many of those U.S. bank holding company swaps dealers themselves, upon recognizing mounting risk in the mortgage markets, shorted the U.S. mortgage market using naked CDS, with their counterparties essentially insuring full mortgage payments. In turn, that led

[91] DAVID ENRICH, THE SPIDER NETWORK: THE WILD STORY OF A MATH GENIUS, A GANG OF BACKSTABBER BANKERS AND ONE OF THE GREATEST SCAMS IN FINANCIAL HISTORY 35 (2017) (Emphasis in original).

to the likelihood of non-payment to the bank holding company swaps dealers of the “insurance” they had purchased from their cash-strapped counterparties when the mortgage market collapsed.

To avoid cascading massive defaults on the viability of the failing U.S. mortgage market, it was the U.S. taxpayer that shelled out trillions of dollars to bail out these, *inter alia*, huge U.S. bank holding company swaps dealers both in their inability to pay the “insurance” and in their threatened inability to collect the insurance from their defaulting counterparties when those swaps dealers were themselves shorting the housing market.[92]

E. Swaps and the CEA’s Exchange Trading Requirement

After swaps had been developed in the 1980s, with a simultaneous recognition that swaps contained the features of a futures contract, the question arose whether swaps would be subject to the mandatory exchange-trading requirement of the CEA.[93] In a 1989 Policy Statement, the CFTC set forth the criteria for the kind of swaps for “which regulation under the CEA and Commission regulations [of swaps would be] unnecessary.”[94] The CFTC concluded that swaps at that time required:

> “[t]ailoring... through private negotiations between the parties and may involve not only financial terms but issues such as representations, covenants, events of default, term to maturity and any requirement for the posting of collateral or other credit enhancement. Such tailoring and counterparty credit assessments distinguish swap transactions from exchange transactions, where the contract terms are standardized and the counterparty is unknown.”[95]

Accordingly, the CFTC exempted swaps from the CEA exchange-trading requirement, by stating that “swaps *must be negotiated* by the parties as to their material terms, based upon *individualized* credit determinations, and documented by the parties in an agreement or series

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[92] Cezary Poduk et al., *10 Years After the Crisis*, WALL STREET J. (Mar. 27, 2018), http://graphics.wsj.com/how-the-world-has-changed-since-2008-financial-crisis/ (“The financial crisis cost the U.S. economy some $6 trillion to $14 trillion in lost output, and ended only after the government promised aid worth an estimated $12.6 trillion.”).

[93] Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (July 21, 1989).

[94] *Id.* (emphasis added).

[95] *Id.* (emphasis added).

of agreements that is *not fully standardized*."[96] Another condition of the exchange trading exemption was that "[t]he swap must not be marketed to the public."[97]

Because the CEA provided no explicit statutory provision authorizing the CFTC to grant this kind of exemption from the CEA's exchange trading requirement, the large U.S. bank holding company swaps dealers*, inter alia*, complained to Congress that there was "uncertainty" as to the legal effect of the CFTC's 1989 policy statement.[98] Thus, to accommodate these large swaps dealers, in 1992 Congress passed the Futures Trading Practices Act ("FTPA"), which authorized the precise criteria for the CFTC to create an exemption from the CEA's mandatory exchange trading requirement for, *inter alia*, "swap agreements" that "are *not* part of a fungible class of agreements that are standardized as to their material economic terms."[99]

The Commission later explained this statutory bar to standardization of swaps as follows:

> "This condition [that swaps be individually negotiated] is designed to assure that the exemption does not encompass . . . swap agreements, the terms of which are fixed and are not subject to negotiation that functions essentially in the same manner as an exchange but for the bilateral execution of transactions."[100]

Pursuant to the CFTC's then new-found ability to grant exceptions to the CEA's exchange-trading requirement, the CFTC by rule in 1993 provided an exception from the CEA's exchange-trading for swaps that were, *inter alia*, "*not* part of a fungible class of agreements that are standardized as to their material economic terms[.]"[101] Moreover, exempt swaps agreements were not to be "traded on or through a multilateral transaction execution facility[.]"[102] In laymen's terms, "a multilateral transaction execution facility" consists of one party offering

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[96] *Id.*

[97] JOHNSON & HAZEN, *supra* note 70, at 53.

[98] Greenberger Testimony, *supra* note 85.

[99] Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3631 (emphasis added).

[100] Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, 5590 (Jan. 22, 1993) (emphasis added).

[101] 17 C.F.R. § 35.2(b) (2009) (emphasis added).

[102] *Id.* § 35.2(d).

electronically a swaps agreement to many different other parties, rather than merely offering agreements on a strictly bilateral or one-on-one basis.[103]

F. The Standardization of Swaps through the ISDA Master Agreement

However, even before the 1993 CFTC exchange-trading exemption had been finalized, calling for "tailored" negotiation of each of the material economic terms of a swap to be exempt from exchange trading, ISDA promulgated, in 1992, a *standardized* and *copyrighted* Master Agreement and related standardized and copyrighted schedules to govern the execution of a swap. ISDA "was chartered in 1985 and today has over [875] member institutions."[104] Under ISDA's rules, one could not trade swaps unless trading with an ISDA member that had the exclusive rights to use ISDA's standardized, copyright agreements. As will be seen, these standardized ISDA-created contracts substantially undercut the CFTC 1993 exchange trading exemption for the "tailoring" of swaps, *i.e*., ISDA swaps contractual template made swaps look exactly like standardized futures contracts and thus, under the CEA, had to be traded on an exchange.[105]

In this regard, the 1992 ISDA Master Agreement was 24 pages long with standardized, boilerplate clauses, and each page carried with it a copyright in ISDA's name.[106] The Agreement included the fundamental provisions without which the swaps transaction could not be understood. Included among the many contractual points resolved by the ISDA Master Agreement are "Interpretation" principles (¶1); "Obligations", including "Liability" (¶2); "Representations" (¶3); "Agreements" (¶4); "Events of Default and Termination Events" (¶5); "Early Termination" (¶6); "Transfer" (¶7); "Contractual Currency" (¶8); "Remedies" (¶9); "Expenses" (¶11); "Notice"

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103 *See* A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, 65 Fed. Reg. 38,986, 38,989 (June 22, 2000) ("The Commission is proposing to define MTEF as 'an electronic or non-electronic market or similar facility through which persons, for their own accounts or for the accounts of others, enter into, agree to enter into or execute binding transactions by accepting bids or offers made by one person that are open to multiple persons conducting business through such market or similar facility.'"); ISDA, *Membership* (2018), https://www.isda.org/membership/ ("ISDA has over 875 member institutions from 68 countries.").

104 Michael Greenberger, *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by an Unregulated Multi-Trillion Dollar Derivatives Market*, 6 J. BUS. & TECH. L. 127, 135 (2011), http://digitalcommons.law.umaryland.edu/cgi/viewcontent.cgi?article=1157&context=jbtl (*quoting* Press Release, ISDA, Eraj Shirvani New Chairman of ISDA (Apr. 16, 2008)) (internal quotation marks omitted); *see also* ISDA, *Membership*, https://www.isda.org/membership/ (last visited Apr. 5, 2018).

105 *See supra* notes 92-102 and accompanying text.

106 *See* Master Agreement, ISDA, 1992.

(¶12); "Governing Law and Jurisdiction" (¶13); and forty-three "definitions" governing the swaps transactions (¶14).[107]

Accompanying the ISDA Master Agreement is a "Schedule," six pages long, derived directly from a standardized ISDA template, which, in turn, provides a standardized menu of limited choices to further define terms of the ISDA Master Agreement.[108] The ISDA template for the Schedule is itself copyrighted on every page in ISDA's name. The ISDA standardized template for the Schedule is dependent upon, and references only, the ISDA Master Agreement.[109]

Also, accompanying the ISDA Schedule is a standardized ISDA Credit Support Annex, which is sixteen pages long and includes copyrights in ISDA's name on every page except those relating to the last of thirteen paragraphs of the annex.[110] The Credit Support Annex is the mechanism by which parties to the swap transaction would adjust the credit arrangement underlying the swap. For example, and critical for a discussion of the U.S. bank-created "de-guarantee loopholes" below, this latter document traditionally served as a downstream guarantee of a swaps dealer subsidiary to a swaps non-dealer counterparty.

G. The CFTC's May 1998 Concept Release Suggesting the Regulation of Swaps

By 1998, swaps were growing at a rapid pace.[111] As the CFTC noted in May 1998:

> "Use of OTC derivatives has grown at very substantial rates over the past few years. According to the most recent market survey by [ISDA], the notional value of new transactions reported by ISDA members in interest rate swaps, currency swaps, and interest rate options during the first half of 1997 increased 46% over the previous six-month period. The notional value of outstanding contracts in these instruments was $28.733 trillion, up 12.9% from year-end 1996, 62.2% from year-end 1995, and 154.2% from year-end 1994. ISDA's 1996 market survey noted that there were 633,316 outstanding contracts in these instruments as of

107 *Id.*

108 *Id.* at 19–24.

109 *Id.*

110 *See Master Agreement, Credit Support Annex to Schedule*, ISDA (1992).

111 Over-the-Counter Derivatives, 63 Fed. Reg. 26,114, 26,114–15 (May 12, 1998).

year-end 1996, up 47% from year-end 1995, which in turn represented a 40.7% increase over year-end 1994."[112]

In addition, by the mid-to-late 90s, swaps, because of the ISDA Master Agreement, were so standardized that they could be traded electronically on a multilateral basis, thereby exhibiting all of the trading characteristics of traditional exchange-traded, standardized futures contracts.[113] Because swaps were increasingly standardized and traded multilaterally, however, that market was not within the "safe harbors" of the CFTC exemption from the CEA's exchange trading requirement provided by the 1989 Swaps Policy Statement or the 1993 Swaps exemption, both of which required bilateral "tailoring" of material terms by the swaps counterparties and barred the trading of swaps multilaterally.[114]

On May 7, 1998, the CFTC promulgated a "concept release" concerning swaps, finding that these products were so standardized and traded multilaterally that they were almost certainly subject to the CEA's mandatory exchange trading requirement (and therefore were trading in violation of the CEA). The concept release called for public comment on the development of various proposed alternative regulatory schemes that would create a workable exemption now authorized by the CEA from that statute's mandatory exchange trading requirement.[115]

The concept release made clear, however, that any new regulatory system would only be applied "*prospectively*," with the then-existing swaps market retroactively permitted under the relatively new exchange trading exemption authority within the CEA.[116]

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[112] *Id*. at 26, 115 (internal citations omitted). Throughout this paper, the metric for the value of swaps is listed as the "notional value." As the concept release itself makes clear, the "actual value" of a swap may more accurately reflect the amount at risk in the swaps trade. The concept release shows that the "actual value" of a swap is about 3% of the notional value. *Id.* Even so, 3% of the notional value of swaps (about $593 trillion) at the time of the 2008 meltdown, still amounts to almost $18 trillion dollars, a large enough number of value at risk to set off the 2008 financial panic; See also *OTC Derivative Statistics at end-December 2017*, Bank for International Settlements (Jun. 11, 2018), https://www.bis.org/publ/otc_hy1805.htm (Bank of International Settlements finds the value at end-June 2017 of outstanding swaps to have a notional value of $542 trillion, recognizing that the gross market value is $13 trillion or about 2.5% of notional value.). Regulatory efforts are in play, *inter alia*, at the CFTC to move away from notional amount metric. James Rundle, *The Risky Business of Splitting Hairs*, Waters Technology (Jun. 8, 2018), https://www.waterstechnology.com/industry-issues-initiatives/3683551/the-risky-business-of-splitting-hairs. Resistance to any change is premised on the fact that the EU, Australia, Hong Kong, Singapore and Canada now use the notional amount metric for market regulation. *Id.*

[113] *See id*. at 26, 115-116.

[114] *See id.* at 26, 116-118.

[115] *Id*.

[116] Over-the-Counter Derivatives, 63 Fed. Reg. 26, 114 *passim* (May 12, 1998).

The concept release was published in the *Federal Register*, and it asked commenters to give their opinions on how and which traditional CEA regulatory requirements should be applied to the swaps market, *e.g.*, reporting and disclosure, capital and collateral adequacy, clearing, exchange trading, regulation of intermediaries, and self-regulation or application of anti-fraud and anti-manipulation principles.[117] The CFTC expressly stated that it had no preconceived notion of the answer to these questions.[118]

H. The Serious Pre-May 1998 Swaps Market Dysfunctions

The motivation for this May 1998 CFTC inquiry derived from the fact that unregulated swaps had, by that time, caused many troublesome financial calamities.[119] The CFTC noted:

> "A number of large, well-publicized, financial losses over the last few years have focused the attention of the financial services industry, its regulators, derivatives end-users, and the general public on potential problems and abuses in the OTC derivatives market. Many of these losses have come to light since the last major regulatory actions by the CFTC involving OTC derivatives, the swaps and hybrid instruments exemptions issued in January 1993."[120]

Among the most prominent scandals deriving from unregulated swaps by May 7, 1998 included the 1994 bankruptcy of Orange County, the largest county default in the Nation's history at that time.[121] Orange County was one of the country's wealthiest counties and the fifth most populous.[122] Having executed many poorly understood interest rate swaps, the county suddenly found itself facing massive debt under those swaps for which it had no reserves.[123] Orange County lost approximately $1.6 billion.[124] The swaps dealer, Merrill Lynch, agreed to pay

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117 *Id*. at 26, 119-122.

118 *Id*. at 26, 114, 116.

119 *Id.* at 26, 115.

120 *Id*. at 26, 115. Also of note, in footnote 6 of the concept release, the CFTC cited "Jerry A. Markham, *Commodities Regulation: Fraud, Manipulation & Other Claims,* Section 27.05 nn. 2-22.1 (1997) (listing 22 examples of significant losses in financial derivatives transactions) [and] a 1997 GAO Report 4 (stating that the GAO identified 360 substantial end-user losses)."

121 MARK BALDASSARE, WHEN GOVERNMENT FAILS: THE ORANGE COUNTY BANKRUPTCY 1 (1998).

122 *Id.*

123 *Id.* at 2.

124 *Id.* at 3.

$400 million to Orange County to settle claims involving the fraudulent nature of the swaps execution that caused Orange County's bankruptcy.[125]

Also beginning in 1994, two large corporate swaps clients of Bankers Trust, Gibson Greetings, and Procter & Gamble successfully sued that bank for defrauding them in the sale of complicated unregulated swaps, thereby causing large losses by those two institutions.[126] Central to that litigation's success were over 6,500 tape recordings of Bankers Trust employees acknowledging to each other that the bank's clients did not understand the adverse impact the executed swaps transactions would have on them.[127]

The SEC and CFTC took cooperative enforcement actions against Bankers Trust for violating the antifraud provisions of the federal securities and commodities laws in connection with the swaps it marketed.[128] The SEC found that Bankers Trust violated various sections of the securities laws, including making false statements or omissions in the sale of securities, supplying materially inaccurate valuations of derivatives transactions, and failing to supervise marketing personnel.[129] The CFTC asserted that Bankers Trust, by its conduct, had, *inter alia*, violated the antifraud provisions of the CEA.[130]

I. Opposition to the CFTC's Suggestion That Swaps Regulation Was Needed

The CFTC's sister financial regulatory agencies (*i.e.*, the Department of the Treasury, the Federal Reserve, and the SEC) within the President's Working Group on Financial Markets

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125 Andrew Pollack & Leslie Wayne, *Ending Suit, Merrill Lynch to Pay California County $ 400 Million*, N.Y. TIMES (June 3, 1998), http://www.nytimes.com/1998/06/03/business/ending-suit-merrill-lynch-to-pay-california-county-400-million.html?pagewanted=all.

126 *See* Bloomberg Business News, *Former Bankers Trust Trader Settles Charges in Derivatives Case*, N.Y. TIMES (Mar. 1, 1996), http://www.nytimes.com/1996/03/01/business/former-bankers-trust-trader-settles-charges-in-derivatives-case.html ("Gibson said it lost more than $6 million in derivatives trading and sued Bankers Trust. The companies settled the suit in November 1994."); Saul Hansell, *Bankers Trust Settles Suit with P.& G*, N.Y. TIMES (May 10, 1996), http://www.nytimes.com/1996/05/10/business/bankers-trust-settles-suit-with-p-g.html ("Paying a steep price to end a bitter battle, the Bankers Trust New York Corporation agreed yesterday to forgive most of the nearly $200 million the bank contended it was owed by Procter & Gamble over two complex transactions in 1993.").

127 Kelley Holland et al., *The Bankers Trust Tapes*, BUSINESSWEEK (Oct. 16, 1995), https://www.bloomberg.com/news/articles/1995-10-15/the-bankers-trust-tapes.

128 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-98-5, OTC DERIVATIVES: ADDITIONAL OVERSIGHT COULD REDUCE COSTLY SALES PRACTICES DISPUTES 1, 8 (1997).

129 *Id.* at 44.

130 *Id.* at 46.

("PWG") were strongly opposed to the CFTC's concept release inquiry.[131] In response to a request from the bank opponents of the concept release,[132] on the day the concept release was formally published, these agencies pressured Congress to stop the CFTC from continuing with the inquiry. Congress eventually enacted a six-month statutory moratorium to the CFTC concept release.[133]

J. The Long Term Capital Management Crisis

By the beginning of September 1998, Long-Term Capital Management ("LTCM") was the country's largest and most successful hedge fund "with a massive derivatives portfolio."[134] LTCM had assured its investors that it was so skilled at hedging risk with swaps that the most it "could ever lose in a day of trading was $35 million."[135] However, in September 1998, it nearly collapsed from the loss, over a period of weeks (beginning with a one day loss of $550 million)[136] of $4.6 billion (or about 90% of its capital) on bad speculative bets made almost completely with unregulated swaps.[137]

The New York Federal Reserve feared that LTCM's collapse would create a cascading failure of many of the nation's biggest banks, which were both the hedge fund's creditors and

131 *Frontline: The Warning* (PBS television broadcast Oct. 20, 2009), http://www.pbs.org/wgbh/pages/frontline/warning/etc/script.html.

132 *See generally* SIMON JOHNSON AND JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2010).

133 *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, OVER-THE-COUNTER DERIVATIVES MARKETS AND THE COMMODITY EXCHANGE ACT 1, 13, 15 (1999) [hereinafter WORKING GROUP, OTC (NOV. 1999)] (discussing legislation limiting the CFTC's rulemaking authority and the Working Group's conclusion that "Congressional action is necessary" to address the CFTC concept release).

134 Alan Pyke, *The Story Behind Clinton's Jab at Sanders' One Wall Street Votes*, THINKPROGRESS, (Feb. 5, 2016), https://thinkprogress.org/the-story-behind-clintons-jab-at-sanders-one-wall-street-vote-86c87cffdba6#.wp5rgj4a0.

135 *Id.*

136 *Id.*

137 *See* REPORT OF THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 1, 38-40 (1999) [hereinafter WORKING GROUP, LTCM (Apr. 1999)]; *see also* WORKING GROUP, OTC (NOV. 1999), *supra* note 132, at 16, 33-34 (referencing the Working Group's prior recommendations for enhanced risk assessments resulting from the LTCM events).

swaps counterparties.[138] So concerned were those financial institutions about the systemic effect of an LTCM collapse that, under the New York Federal Reserve's orchestration (in what has been called "a dress rehearsal for the 2008 collapse,"), on September 23, 1998 (with about 48 hours' notice of the likely LTCM failure), fourteen of those institutions contributed a total of $3.6 billion to buy out the fund to keep it from failing and from creating worldwide economic havoc.[139]

K. The President's Working Group's ("PWG") April 1999 Report on LTCM Suggesting Some Regulation of Swaps

After a full day of hearings before the House Financial Services Committee on October 1, 1998 about the LTCM crisis, the President's Working Group was asked by that committee to prepare a report on the LTCM near-failure and recommend actions to prevent such a potentially- systemic financial collapse in the future.[140] In April 1999, the PWG issued that report. It noted therein: "The near collapse of [LTCM], a private sector investment firm, highlighted the possibility that problems at one financial institution could be transmitted to other institutions, and potentially pose risks to the financial system."[141]

One of the major recommendations of the April 1999 PWG report was that the SEC, the CFTC, and the Treasury receive expanded authority to require swaps counterparties to provide: (1) swaps credit risk information; (2) recordkeeping and reporting; and (3) data on concentrations, trading strategies, and risk models, as well as providing an as yet-to-be-designated fed-

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138 *See* WORKING GROUP, LTCM (Apr. 1999), *supra* note 136, at 15 (describing how LTCM's counterparties' exposures were "not adequately assessed, priced, or collateralized relative to the potential price shocks the markets were facing at the end of September 1998, relative to the creditworthiness of the LTCM Fund at that time").

139 *Id.* at 14.

140 *See generally id.* at 29 (summarizing the conclusions and recommendations by the President's Working Group on Financial Markets).

141 *Id.* at viii.

eral regulator the ability to inspect risk management models relating, *inter alia*, to swaps exposures.[142] Federal Reserve Chairman Greenspan declined to endorse this set of recommendations but deferred to those PWG regulators with supervisory market regulation authority.[143] None of these April 1999 PWG recommendations were ever adopted.

L. The November 1999 PWG Report Recommending the Deregulation of Swaps

By November 1999, LTCM had long since been saved and, once saved, quickly closed by the new bank owners. At that time, the PWG (in a complete reversal from its April 1999 Report) recommended to Congress that swaps expressly be totally deregulated.[144] The makeup of the PWG had changed since its April 1999 Report. Lawrence Summers had replaced Robert Rubin as Secretary of the Treasury and Chair of the PWG; and William Rainer had replaced Brooksley Born as Chair of the CFTC and as one of the four principals of the PWG. Rubin (supported by Gary Gensler, then Under Secretary of the Treasury for Domestic Finance and future Obama Chairman of the CFTC) and Brooksley Born had been the driving forces behind the April PWG report, recognizing in varying degrees that swaps trading was not self-regulating and was also systemically risky.[145] The transition to Summers and Rainer, notable opponents of swaps regulation, led to the November 1999 change in the deregulatory swaps policy direction of the PWG.[146]

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142 *Id.* at 39-40.

143 *Id.* at 39 n.23.

144 *Id.*

145 Brooksley Born is now widely recognized as the highest profile regulator first to sound the warning alarms about the dangers of unregulated OTC derivatives, a decade before the 2008 financial meltdown occurred. *Frontline: The Warning*, *supra* note 130. After the LTCM fiasco, Robert Rubin said: "Treasury . . . had [its] own concerns about the risks of [then unregulated] derivatives." Typifying this attitude is a conversation he retells in his memoirs with his then under-secretary Lawrence Summers; in response to Rubin's suggestion that comprehensive margin requirements would be a net positive swaps rule, Summers responded that such rules would be like, "playing tennis with wooden rackets." ROBERT RUBIN & JACOB WEISBERG, IN AN UNCERTAIN WORLD: TOUGH CHOICES FROM WALL STREET TO WASHINGTON 198 (2003).

146 For a concise review of Summers's record on swaps during the Clinton administration, see Michael Hirsh, *The Comprehensive Case Against Larry Summers*, THE ATLANTIC (Sept. 13, 2013), https://www.theatlantic.com/business/archive/2013/09/the-comprehensive-case-against-larry-summers/279651/. William Rainer's advocacy for deregulation began immediately upon taking office. Michael Schroeder, *CFTC Chairman Seeks to Deregulate Trading*, WALL ST. J., Oct. 29, 1999, https://www.wsj.com/articles/SB941126414489211010.

In a cover letter for that November 1999 PWG report, the PWG chairman, Treasury Secretary Summers, explained the PWG's new rationale for seeking the express statutory deregulation of derivatives:

> "Over-the-counter derivatives have transformed the world of finance, increasing the range of financial products available to corporations and investors and fostering more precise ways of understanding, quantifying, and managing risk. These important markets are large and growing rapidly. At the end of 1998, the estimated notional value of OTC derivative contracts was $80 trillion, according to the Bank for International Settlements. In addition, these global markets have been marked by innovation in products and trading and settlement mechanisms.
>
> A cloud of legal uncertainty has hung over the OTC derivatives markets in the United States in recent years, which, if not addressed, *could discourage innovation and growth of these important markets and damage U.S. leadership in these arenas by driving transactions off-shore . . . .*"[147]

The central and key recommendation within the PWG November 1999 Report with respect to swaps was that Congress provide "[a]n exclusion from the CEA['s regulatory requirements] for bilateral transactions between sophisticated counterparties (other than transactions that involve non-financial commodities with finite supplies) . . . ."[148]

M. The Commodity Futures Modernization Act of 2000's Complete Deregulation of Swaps

Accordingly, on the last day of the lame duck 106th Congress, December 15, 2000 ("while the media was focused on the [Presidential] election's recounts")[149], Congress, with the hearty endorsement of then-Secretary Summers on behalf of fellow PWG principals Levitt, Greenspan, and Rainer,[150] passed (with only four dissenting votes in the House) a 262-page rider to an 11,000 page omnibus appropriation measure – with only that day's consideration of

[147] *See supra* note 132, at 1 (3) (emphasis added.).

[148] *See id.* at 2 (8).

[149] Paul Blumenthal, *How Congress Rushed a Bill that Helped Bring the Economy to Its Knees*, HUFF. POST, May 11, 2009, http://www.huffingtonpost.com/paul-blumenthal/how-congress-rushed-a-bil_b_181926.html.

[150] The Commodity Futures Modernization Act of 2000: Floor Debate Before the Senate, 106th Cong. S11947 (daily ed. Jan. 2, 2001) (Letter from Lawrence Summers, Secretary, Department of the Treasury), https://www.congress.gov/congressional-record/2001/01/02/senate-section/article/S11946-1.

the rider's legislative language[151] (which was widely reported as having been "unread by most" members of Congress).[152] On December 21, 2000, President Clinton signed into law the Commodity Futures Modernization Act of 2000 ("CFMA").[153]

The CFMA removed swaps transactions from *all* requirements of exchange trading and clearing under the CEA, as well as from federal anti-fraud and anti-manipulation provisions, so long as the counterparties to the swap were "eligible contract participants."[154] Generally speaking, a counterparty was an "eligible contract participant" if it had in excess of $10 million in total assets with some limited exceptions allowing lesser amounts in the case of an individual using the swap for risk management purposes.[155]

Thus, after passage of the CFMA, the swaps market (at the time, according to Secretary Summers, amounting to $80 trillion in notional value) was exempt from the CEA's capital adequacy requirements; reporting and disclosure; regulation of intermediaries; self-regulation; bars on fraud, manipulation,[156] and excessive speculation; and requirements for exchange trading and clearing. The SEC was similarly barred from "securities" swaps oversight except for quite limited fraud jurisdiction.[157]

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151 Alan Pyke, *The Story Behind Clinton's Jab at Sanders' One Wall Street Votes*, THINKPROGRESS, Feb. 5, 2016, https://thinkprogress.org/the-story-behind-clintons-jab-at-sanders-one-wall-street-vote-86c87cffdba6#.wp5rgj4a0.

152 *Id*.

153 Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763. ("Also, hidden within the bill was an exemption for energy derivative trading, which would later become known as the 'Enron loophole' - this loophole would provide the impetus for Enron's nose dive into full blown corporate corruption."); Paul Blumenthal, *How Congress Rushed a Bill that Helped Bring the Economy to Its Knees*, HUFF. POST, May 11, 2009, http://www.huffingtonpost.com/paul-blumenthal/how-congress-rushed-a-bil_b_181926.html.

154 *See* Greenberger Testimony, *supra* note 85, at 9.

155 JOHNSON & HAZEN, *supra* note 70, at 328-329.

156 Unlike financial swaps, which were "*excluded*" from the exchange-trading requirement, including fraud and manipulation prohibitions, energy and metals swaps, while relieved of the exchange-trading requirement, continued to be subject to fraud and manipulation prohibitions; they were therefore labeled by the CFMA as "*exempt*" transactions. *Id. cf.* § 2(g) (relating to financial swaps), *with* § 2(h) relating to energy and metals swaps. *Id. See also* CHARLES W. EDWARDS ET AL., COMMODITY FUTURES MODERNIZATION ACT OF 2000: LAW AND EXPLANATION 28 (2001) (quoting remarks of Sen. Tom Harkin, 146 CONG. REC. S11896 (Dec. 15, 2000) ("The Act continues the CFTC's anti-fraud and anti-manipulation authority with regard to exempt transaction in energy and metals derivative markets.")). By exempting metals and energy swaps from the exchange-trading requirement, Congress disagreed with the unanimous recommendation of the PWG that swaps concerning "finite" supplies not be removed from the exchange-trading mandate of the CEA. *Id.*

157 *See* Greenberger Testimony, *supra* note 85, at 10.

Recognizing that the deregulation of swaps would remove the CEA's bar to excessive speculation through swaps, the CFMA, in order to expressly and to clearly afford an unfettered statutory right to speculate with swaps, preempted state gaming and state anti-bucket shop laws. Thus, using swaps to place bets on the direction of virtually every financial index was completely authorized without any federal or state oversight.[158]

Finally, to ensure that not even violations of the CFMA itself by swaps dealers could be used as a basis to challenge the legality of a swap, the Act provided that

> "[n]o agreement, contract, or transaction between eligible contract participants . . . shall be void, voidable, or unenforceable . . . based *solely on the failure . . . to comply with the terms or conditions of an exemption or exclusion from any provision of this chapter or regulations of the Commission*."[159]

Thus, a central premise of hundreds of years of the Anglo-American common law governing contracts, *i.e.,* that illegal contracts are subject to a judicial declaration of unenforceability, was abolished by the CFMA as a legal remedy in the swaps market.[160]

In effect, after the passage of the CFMA, almost no law of any kind applied to the swaps market.[161] As would be expected, it has since been widely observed that the rushed passage of the CFMA "was a propellant of the 2008 [financial] crises."[162]

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158 *Id.*

159 7 U.S.C. § 25 (a)(4) (2006) (emphasis added).

160 *See* Greenberger Testimony, *supra* note 85, at 10.

161 *Id.*

162 *See* Paul Blumenthal, *How Congress Rushed a Bill that Helped Bring the Economy to Its Knees*, HUFF. POST (May 11, 2009), http://www.huffingtonpost.com/paul-blumenthal/how-congress-rushed-a-bil_b_181926.html; Sophie Roell, *The Causes of the Financial Crisis*, SALON.COM (Apr. 9, 2012), http://www.salon.com/2012/04/09/the_causes_of_the_financial_crisis/; Barry Ritholtz, *The Few Who Won't Say 'Sorry' for Financial Crisis*, BLOOMBERG (July 27, 2015), https://www.bloomberg.com/view/articles/2015-07-27/no-apologies-from-phil-gramm-for-financial-crisis; David Corn, *Foreclosure Phil*, MOTHERJONES (July/August 2008), http://www.motherjones.com/politics/2008/05/foreclosure-phil; JENNIFER S. TAUB, OTHER PEOPLE'S HOUSES: HOW DECADES OF BAILOUTS, CAPTIVE REGULATORS, AND TOXIC BANKERS MADE HOME MORTGAGES A THRILLING BUSINESS 238 (2014); *Interview: Joseph Stiglitz*, FRONTLINE (July 28, 2009), http://www.pbs.org/wgbh/pages/frontline/warning/interviews/stiglitz.html; David Min and Pat Garofalo, *Regulating Derivatives Traffic*, Center for American Progress (Apr. 19, 2010), https://www.americanprogress.org/issues/economy/news/2010/04/19/7597/regulating-derivatives-traffic/; *see generally* PERMANENT SUBCOMMITTEE ON INVESTIGATIONS OF THE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS, WALL STREET AND THE FINANCIAL CRISIS: ANATOMY OF A FINANCIAL COLLAPSE (April 13, 2011), http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

III. The 2008 Economic Meltdown as a Product of Unregulated Swaps

Although many factors contributed to the financial meltdown of 2008, it is now almost universally recognized that principal among them was the collapse of the unregulated swaps market. Credit default swaps (the buying and selling of insurance on the viability of assets actually owned by an insured counterparty), especially "naked" CDS (the buying and selling of insurance of assets *not* owned by the insured), provided the trigger that launched the mortgage crisis, credit crisis, and systemic fiscal crisis that threatened to implode the global financial system, save for the multi-trillion dollar U.S. taxpayer bailout.[163]

A. CDSs and "Naked" CDSs Foremost Role in the Meltdown

At the time of the crisis, the unregulated swaps market was estimated to have a notional value of $596 trillion, including approximately $58 trillion in CDS and naked CDS,[164] yet federal and state regulators were almost completely barred from swaps oversight and from any knowledge of that market.[165] Before explaining below the manner in which CDS (especially "naked" CDS) fomented this crisis, it is worth citing in the footnotes below those many economists,[166]

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[163] *See generally* Vikas Bajaj, *Surprises in a Closer Look at Credit-Default Swaps*, N.Y. TIMES, Nov. 5, 2008, at B0; Peter S. Goodman, *Taking Hard New Look at a Greenspan Legacy*, N.Y. TIMES, Oct. 9, 2008, at A0; Jon Hilsenrath et al., *Worst Crisis Since '30s, With No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1; *The Financial Crisis and the Role of Federal Regulators: Hearing Before the H. Comm. on Oversight and Gov't Reform*, 111th Cong. 15 (2008), https://www.gpo.gov/fdsys/pkg/CHRG-110hhrg55764/pdf/CHRG-110hhrg55764.pdf (prepared testimony of Dr. Alan Greenspan); Frank, of Dodd-Frank, is concerned over Trump regulators, 2017 WL 3085011; 17 CFR 1.3(hhh)(1); 156 Cong. Rec. S5907 (daily ed. July 15, 2010).

[164] Naohiko Babo & Paola Gallardo, *OTC Market Activity in the Second Half of 2007*, BANK FOR INT'L SETTLEMENTS (May 2008), http://www.bis.org/publ/otc_hy0805.pdf.

[165] Michael Greenberger, *Is Our Economy Safe? A Proposal for Addressing the Success of Swaps Regulation*, *in* WILL IT WORK? HOW WILL WE KNOW? THE FUTURE OF FINANCIAL REFORM 37 (Michael Konczal ed., 2010).

[166] *See* Moshinsky, *supra* note 2; Blinder, *supra* note 2; Hu, *supra* note 2; Krugman, *supra* note 2; *Wall Street Fraud and Fiduciary Duties: Can Jail Time Serve as an Adequate Deterrent for Willful Violations?: Hearing Before the S. Subcomm. on Crime and Drugs*, 111th Cong. 127 (2010), https://www.gpo.gov/fdsys/pkg/CHRG-111shrg63555/pdf/CHRG-111shrg63555.pdf (statement of James K. Galbraith, Lloyd Bentsen, Jr. Chair in Government/Business Relations, Lyndon B. Johnson Sch. of Pub. Affairs, The Univ. of Texas at Austin); Ravi Velloor, *In Good Company: Ex-IMF Chief Economist Raghuram Rajan, The Man Who Foresaw 2008 Financial Crisis*, THE STRAITS TIMES (May 28, 2017), http://www.straitstimes.com/opinion/man-who-foresaw-2008-financial-crisis ("Among the speakers that year was Dr. Raghuram Rajan, the chief economist of the International Monetary Fund who was given the job two years earlier at age 40. It was meant to be a celebration of the Greenspan era but what the audience, which included Mr. Greenspan, heard from Dr. Rajan was a prognosis of dire tidings to come. Dr. Rajan warned against credit-default swaps, which act as insurance against bond defaults, going sour and said there was also immense systemic risk if banks failed to meet their obligations."); Jack Rasmus, *Financial Asset Bubbles: From Subprimes and Credit Default Swaps (CDS) in 2008 to Bitcoin, Cryptocurrency and Exchange Traded Funds (ETFs) in 2018*, Global Research (Dec. 13, 2017), https://www.globalresearch.ca/financial-asset-bubbles-from-subprimes-and-credit-default-swaps-cds-in-2008-to-bitcoin-cryptocurrency-and-exchange-traded-funds-etfs-in-2018/5622737; *Protecting Financial Stability and Enhancing Competitiveness in the Derivatives Markets: Hearing on Legislative Proposals Regarding Derivatives Before the H. Comm. on Fin. Servs.* (Feb. 14, 2018) (statement by Andy Green), (transcript available at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-agreen-20180214.pdf).

regulators,[167] investigating commissions,[168] market observers,[169] and financial columnists[170] who have described the central role unregulated CDS and naked CDS played in the crisis.[171] In the

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[167] Edmund L. Andrews, *Greenspan Concedes Error on Regulation*, N.Y. TIMES (Oct. 24, 2008), http://www.nytimes.com/2008/10/24/business/economy/24panel.html; Anthony Faiola et al., *What Went Wrong*, WASH. POST, Oct. 15, 2008; Peter S. Goodman, *Taking Hard New Look at the Greenspan Legacy*, N.Y. TIMES (Oct. 9, 2008), http://www.nytimes.com/2008/10/09/business/economy/09greenspan.html; *Hearing to Review the Role of Credit Derivatives in the U.S. Economy: Hearing Before the H. Comm. on Agriculture*, 110th Cong. 79 (Nov. 20, 2008), https://www.gpo.gov/fdsys/pkg/CHRG-110hhrg51569/pdf/CHRG-110hhrg51569.pdf (prepared testimony of Eric R. Dinallo, Superintendent, N.Y. State Insurance Dep't) [hereinafter Dinallo Testimony]; Gary Gensler, Remarks at OTC Derivatives Reform, Chatham House, London (Mar. 18, 2010), http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-35 (stating that "OTC derivatives were at the center of the 2008 financial crisis" and that "[c]apital requirements should take into account the unique risks that credit default swaps (CDS) pose"); Greg Robb, *Roots of Credit Crisis Laid at Fed's Door*, MARKET WATCH (Oct. 24, 2007), http://www.marketwatch.com/story/roots-of-credit-crisis-found-at-the-feds-door-says-expert; Chairman J. Christopher Giancarlo, Address before Derivcon 2018, New York City, New York (Feb. 1, 2018) (transcript available at http://www.cftc.gov/PressRoom/PressReleases/opagiancarlo35); Cassandra Jones Havard, *Too Conflicted to be Transparent: Giving Affordable Financing its 'Good Name' Back*, 30 LEGISLATION AND PUBLIC POLICY 45, (2017), *available at* http://scholarworks.law.ubalt.edu/all_fac/1059; CFTC Commissioner Rostin Behnam, Address at the Georgetown Center for Financial Markets and Policy, The Dodd-Frank Inflection Point: Building on Derivatives Reform (Nov. 14, 2017) (transcript available at http://www.cftc.gov/PressRoom/PressReleases/opabehnam1) ("Over-the-counter swaps did not singularly cause the financial crisis, nor would their direct regulation have prevented a crisis; but, unregulated, over-the-counter derivatives certainly played a key part in the crisis, and the policy response was appropriately swift."); CFTC looks to rewrite swap data reporting standards, 2017 WL 2927943.

[168] *See, e.g.*, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NAT'L COMM'N ON THE CAUSES OF THE FIN. AND ECON. CRISIS (2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf; Scott W. Bauguess, The Role of Big Data, Machine Learning, and AI in Assessing Risks: A Regulatory Perspective, Champagne Keynote Address: OpRisk North America 2017, New York, New York (June 21, 2017), https://www.sec.gov/news/speech/bauguess-big-data-ai; Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States," Jan. 2011, at 386, available at http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

[169] *See* INVESTORS' WORKING GROUP, U.S. FIN. REGULATORY REFORM: THE INVESTORS' PERSPECTIVE 1 (July 2009), http://www.cii.org/files/issues_and_advocacy/dodd-frank_act/07_01_09_iwg_report.pdf (listing the fundamental flaws of the U.S. financial services sector exposed by the credit crisis: " . . . gaps in oversight that let purveyors of abusive mortgages, complex over-the-counter (OTC) derivatives and convoluted securitized products run amok; woefully underfunded regulatory agencies; and super-sized financial institutions that are both 'too big to fail' and too labyrinthine to regulate or manage effectively"); Jonathan Berr, *George Soros Wants to Outlaw Credit Default Swaps*, DAILYFINANCE (June 12, 2009), https://www.aol.com/article/2009/06/12/george-soros-wants-to-outlaw-credit-default-swaps/19065423/ ("Credit default swaps, insurance contracts on securities in the event of a default, are widely blamed as one of the causes of the current financial crisis. The unregulated, $70 trillion market became unhinged when the real estate market, particularly houses funded through subprime mortgages, collapsed."); Henny Sender, *Greenlight Capital Founder[David Einhorn] calls for CDS ban*, FIN. TIMES, Nov. 6, 2009, http://www.ft.com/cms/s/0/6b1945e6-caf9-11de-97e0-00144feabdc0.html [subscription required] (quoting Greenlight Capital founder David Einhorn: ". . . trying to make safer credit default swaps is like trying to make safer asbestos . . . [as CDSs create] large, correlated and asymmetrical risks"); Janet Tavakoli, *Washington Must Ban U.S. Credit Derivatives as Traders Demand Gold (Part One)*, HUFF. POST, May 8, 2010, http://www.huffingtonpost.com/janet-tavakoli/washington-must-ban-us-cr_b_489778.html ("Congress should act immediately to abolish credit default swaps on the United States, because these derivatives will foment distortions in global currencies and gold."); LEWIS, *supra* note 1 (providing a history of the 2008 financial collapse and demonstrating the central role of derivatives); *see supra* note 2; Matthew Henry, *Blockchain and Credit Default Swaps – Part 1, An Overview*, FINTECHBLUE (Sept. 5, 2017), http://www.fintechblue.com/2017/09/blockchain-and-credit-default-swaps-an-overview/.

[170] *See* LAWRENCE G. MCDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS (2009); Robert Johnson, *Credible Resolution – What It Takes to End Too Big to Fail, in* ROOSEVELT INST.: MAKE MARKETS BE MARKETS 117–33 (2009) ("The recent crisis in the U.S. centered on the collapse of the housing bubble and the role of leverage, off balance sheet exposures, and complex OTC derivatives."); Vikas Bajaj, *Surprises in a Closer Look at Credit-Default Swaps*, N.Y. TIMES (Nov. 5, 2008), http://www.nytimes.com/2008/11/05/business/05swap.html ("Policy makers have been unnerved by the rise of the [CDS] market because they are worried that sellers of protection may not have enough reserves to pay future claims and that default by one party could lead to a cascade of failures throughout the financial system."); Jon Hilsenrath et al., *Worst Crisis Since '30s, With No End In Sight*, WALL ST. J., SEPT. 18, 2008, at A1 ("The latest trouble spot [in the financial crisis] is an area called credit-default swaps . . . ."); Jeff Madrick, *At the Heart of the Crash*, N.Y. REV. OF BOOKS (June 10, 2010) (reviewing LEWIS, *supra* note 1), http://www.nybooks.com/articles/archives/2010/jun/10/heart-crash/?pagination=false ("As we now know, derivatives were the instruments that enabled Wall Street to stretch capital dangerously far—and were at the center of the financial crisis that began that year."); Gretchen Morgenson, *Naked Came the Speculators*, N.Y. TIMES (Aug. 10, 2008), http://www.nytimes.com/2008/08/10/business/10gret.html ("As the sheriffs begin to confront the C.D.S. cowboys, more losses are bound to show up in this Wild West."); Kimberly Amadeo, *Credit Default Swap: Pros, Cons, Crises, Examples: How a Boring Insurance Contract Almost Destroyed the Global Economy*, The Balance (Aug. 17, 2017), https://www.thebalance.com/credit-default-swaps-pros-cons-crises-examples-3305920; Camilla

margin below, a competing theory advanced as the meltdown's causation, *i.e.,* the so-called "run on repos," is considered, and while recognized as important, it is, nevertheless, deemed derivative of the defaults or threatened defaults by worldwide financial institutions in the hundreds or trillions of dollars notional value in the swaps market.[172]

CDSs were the last step in a mortgage securitization process that ultimately undermined the economy in 2008.[173] A counterparty investing in a CDS paid a very small insurance-like "premium" to another counterparty for the latter to agree to "guarantee" in the entirety portions of mortgage indebtedness owned by the insured counterparty. However, investors soon developed a widely adopted method of "shorting" the mortgage market by handpicking (but not owning) multi-trillion parts of another financial instrument, a collateralized debt obligation ("CDO"), to be insured against failure*: i.e.,* a "naked" CDS. Thus, CDS and naked CDS can be seen as a form of insurance on specified tranches of a CDO, which in the case of "naked" CDSs,

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Hodgson, *The Risky Product Blamed for Worsening the Financial Crisis is Back on the Rise*, BUS. INSIDER (Aug. 24, 2017), http://www.businessinsider.com/credit-default-swaps-post-financial-crisis-product-popular-again-2017-8; Ekaterina Klenina and Cesario Mateus, *Global Financial Crisis and Price Discovery between Credit Default Swaps Premia and Bond Yield Spreads*, SSRN ELEC. J. (Aug. 2017), https://www.researchgate.net/publication/319260395_Global_Financial_Crisis_and_Price_Discovery_between_Credit_Default_Swaps_Premia_and_Bond_Yield_Spreads.

171 *See supra* notes 165-169; *Credit Default Swap: Insurance Against Non-Payment*, CORP. FIN. INST. (2018), https://corporatefinanceinstitute.com/resources/knowledge/finance/credit-default-swap-cds/; Kimberly Amadeo, *The 2008 Financial Crisis: A Look at the Causes, Costs and Weighing the Chances of It Happening Again*, THE BALANCE (Jan. 22, 2018), https://www.thebalance.com/2008-financial-crisis-3305679.

172 It has been suggested that the 2008 financial meltdown was principally caused by a so-called "run on repos." See the survey in Edward J. Kane, *Please Don't Throw Me in the Briar Patch: the Flummery of Capital-Requirement Repairs Undertaken in Response to the Great Financial Crisis*, *in* MONEY, REGULATION & GROWTH: FINANCING NEW GROWTH IN EUROPE 93 (Marc Qintyn et al. eds., 2014); Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo* (Nat'l Bureau of Econ. Research, Working Paper No. 15223, 2009). The run on repos refers to the withdrawal of short-term (often overnight) extensions of credit to banks needed to maintain bank solvency. Repos, or repurchase agreements, are generally overnight loans provided to banks by repo lenders (such as money market funds, foreign financial institutions, mutual funds, and other unregulated cash pools) that are, in turn, secured by a bank's collateral, such as asset-backed securities, collateralized-debt obligations ("CDOs"), or credit-default swaps. Gary B. Gorton & Andrew Metrick, *Who Ran on Repo* 1 n.1 (Nat'l Bureau of Econ. Research, Working Paper No. 18455, 2012) (explaining that a repo contract is "often overnight"). Prior to the 2008 meltdown, these repurchase agreements were withdrawn because of repo lenders' concerns about bank insolvency, and as the repo market increasingly tightened, this repo-dependent bank's probability of insolvency increased. However, the "run on repos" theory ignores the underlying and fundamental cause of that run: *i.e*., the real or apparent inability of the bank to perform on trillions of dollars of swaps obligations. Those real or pending swaps defaults highlighted to their repo lenders the bank's lack of credit worthiness and thus the bank's inability to finance debt by, *inter alia*, using repos. In other words, when these bank counterparties could no longer afford to pay off their swaps debts, no lender would risk extending repo financing, the repayment of which similarly seemed unlikely. Thus, while there can be no doubt that the failure of the repo market *contributed* to the 2008 financial havoc, in the absence of threatened defaults in the trillion dollar swaps market, banks would almost certainly have otherwise been deemed creditworthy in the repo market. As a result, because of the obvious, impending trillion dollar defaults in the swaps markets, banks were largely cut off from one of their most needed sources of borrowing: repos.

173 *See* U.S. FIN. CRISIS INQUIRY COMM'N, *supra* note 167, at 134, 201, 267.

were not owned by the "insured."[174] CDOs, in turn, involved the "pulling together and dissection into 'tranches' of huge numbers of [mortgage-backed securities ("MBSs")]," based for their part on actual mortgage loans and, in the years before the crisis, subprime mortgages in particular.[175]

Importantly, by constantly "reframing the form of risk" (*e.g.*, moving mortgage loans to inclusion within mortgage backed securities ("MBS") to the inclusion of MBS within CDOs, swaps dealers, providing the guarantees or insurance of the underlying mortgages through CDS and naked CDS, lost the thread on the safety of these investments.[176] This problem was compounded by "misleadingly high evaluations" (often investment grade ratings) by credit rating agencies of the CDOs being insured by CDSs and naked CDSs.[177] In addition, issuers of these kinds of CDSs relied upon the faulty assumption widely held pre-2008 that housing prices would never go down, so that the provider of the "insurance" would never have to pay the guarantees of continuous and uninterrupted mortgage payments made through the swaps.[178]

Because of the widespread assumption by the issuers of CDSs' and naked CDSs' guarantees that mortgages could always be paid through refinancing at appreciated housing values (and therefore could never fail), it was widely and mistakenly understood to be risk-free to guarantee mortgage payments.[179] Those taking these guarantees, *i.e.,* the "shorts," bet with relatively small insurance-type premiums that their handpicked mortgage-based instruments (hand-selected tranches of CDOs), *which they did not own*, would fail, and those shorting mortgages would then receive a hefty payment of the full value of those failed mortgages reflected in the CDOs upon collapse of those instruments.[180]

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174 *Id.*

175 *Id*. at 155.

176 *Id.* at 142-43.

177 *Id.* at 50, 134.

178 *Id.* at 132, 194-95, 202.

179 *Id.* at 50, 195.

180 *Id.* at 213.

All of this came to a head when housing prices began to plummet.[181] Homeowners began to default first on subprime mortgages (and then on prime mortgages), leading to the failure of CDO tranches, thereby triggering trillions of dollars of non-capitalized payments by the CDS and naked CDS issuers.[182] In addition, because these kinds of swap instruments were not required to be, and were not, reported to financial regulators, the federal financial regulators (and investors as a whole) lacked knowledge of the crisis "bottom." They were thus shocked when they learned the huge size of the swaps market, which, in turn, exacerbated the tightening of credit throughout the economy because even apparently financially viable institutions could be swaps counterparties facing massive swaps defaults, thereby becoming a credit risk.[183] All of this resulted in the expedited downward cycle of the economic meltdown, exacerbated by the fact that CDOs, CDSs and naked CDSs existed not just in the mortgage market, but in most debt markets.[184]

Informed estimates are that there were three to four times as many "naked" CDS instruments insuring against mortgage defaults at the time of the meltdown than those CDSs guaranteeing actual lending risk by holders of CDOs and MBSs.[185] This meant that, to the extent the guarantor of a naked CDS (*e.g.,* AIG) had to be rescued by the U.S. taxpayer, the chances were very high that that "bail out" money ultimately went directly from AIG, for example, to those who speculated that sets of handpicked mortgage loans would fail.[186] Prominent members of Congress have maintained that the holders of the short bets of these swaps (*i.e.*, those that speculated that mortgages they did not own would fail) formed a strong political constituency

[181] *Id.* at 57.

[182] *Id.* at 195.

[183] *Id.*

[184] *Id.*

[185] *Id.* at 101; *see* Dinallo Testimony, *supra* note 166, at 80 ("[I]t appears that swaps on that debt could total at least three times as much as the actual debt outstanding."); Dawn Kopecki & Shannon D. Harrington, *Banning 'Naked' Default Swaps May Raise Corporate Funding Costs*, BLOOMBERG (July 24, 2009); Krugman, *supra* note 2.

[186] *See* Dinallo Testimony, *supra* note 166, at 79.

opposing the "rescue" of distressed homeowners through the adjustment of mortgages in bankruptcy to keep homeowners from mortgage defaults and in their homes.[187]

In this regard, a recent study by social scientists Ferguson, Jorgensen, and Chen shows that campaign contributions from financial houses significantly affected the way in which Congressional representatives' voted on a series of bills seeking to aid consumers and/or otherwise dismantle Dodd-Frank.[188] Because the low number of Senators made "reliable statistical analysis [of the Senate] problematic," their study analyzed the voting behavior within the House of Representatives.[189] The study found that the finance and real estate sector contributed "over $90 million" to representatives in the House "for [a recent] election cycle," a large majority of which contributions they found surprisingly went to Democratic candidates, given the pro-regulatory bias of that party.[190]

In their first statistical analysis, which focused solely on House Democrats' voting behavior on financial deregulation, the researchers found that "for every $100,000 that Democratic representatives received from finance, the odds they would break with the party['s support for financial regulation] increased by 13.9 percent."[191] Given the magnitude of the $90 million contributions from financial interests and the relatively low amount of money associated with changing House Democrats' voting behavior, these contributions led and will likely continue to lead a significant number of Democrats voting to dismantle financial regulation.[192] Elsewhere in this paper, there is discussion of further support for the Ferguson, *et al.,* thesis, *i.e.,* the recent

[187] *See* Thomas Ferguson et al., *Fifty Shades of Green*, ROOSEVELT INST. (May 2, 2017), http://rooseveltinstitute.org/fifty-shades-green/ (describing how bank contributions to Congress members impacts their voting); Ryan Grim, *Dick Durbin: Banks "Frankly Own the Place,"* HUFF. POST (Apr. 29, 2009), http://www.huffingtonpost.com/2009/04/29/dick-durbin-banks-frankly_n_193010.html.

[188] *See* Ferguson et al., *supra* note 186.

[189] *See id.* at 10.

[190] *See id.* at 26.

[191] *See id.* at 30.

[192] *See id.* at 26, 35.

bipartisan passage of a Senate Dodd-Frank deregulation bill (S.2155), with 16 Democratic Senators joining a straight-line Republican deregulatory vote to make this bill filibuster proof. [193]

Ferguson, *et al.'s*, second statistical analysis included both Republican and Democrat members in the House.[194] That separate analysis found that for House members, regardless of party affiliation, "for every $1,000 increase in money from finance, the odds of a vote against the banks decrease[d] by 0.21 percent."[195] Given that financial interests contributed over $90 million in a single election cycle to House members, banks could easily pay enough to improve substantially the odds of a deregulatory vote in their favor.[196]

Also, the fact that "naked" CDSs were nothing more than "bets" on the viability of the U.S. mortgage market also demonstrates the importance of the CFMA having expressly preempted state gaming and anti-bucket shop laws.[197] Had those laws not been preempted, it is almost certain that at least some states would have banned these investments as unlicensed gambling or illegal bucket shops.[198] An action of that sort by even a single state would have early on brought a timely end to the "naked" CDS market throughout the country.[199]

B. Counterparty Interconnectedness: The Systemic Risk Derived from All Types of Swaps

The entirety of the unregulated swaps market (not just CDS and "naked" CDS) was central to the 2008 crisis's causation. That is principally because the swaps markets as a whole are so highly interconnected. Defaults in one segment of that market necessarily would lead to defaults in the entire market. As shown below, the prevention of a cascading collapse of the financial system therefore required the American taxpayer to bail out huge U.S. bank holding

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[193] *See id.* at 35.

[194] *See id.* at *42*.

[195] *See id.* at 42.

[196] *See id.* at 26.

[197] JOHNSON & HAZEN, *supra* note 70, at 975 (referencing 7 U.S.C. § 16(e)(2)).

[198] *See* Dinallo Testimony, *supra* note 166, at 81.

[199] Greenberger Testimony, *supra* note 85.

company swaps dealers not only because of their CDS and naked CDS commitments, but because of threatened defaults across all their swaps lines.[200]

1. The Lehman Bankruptcy Evinces the Complete Financial Interconnectedness through Swaps of The World's Large Financial Institutions

For example, the losses at Lehman – the only big U.S. bank allowed to fail in the 2008 financial meltdown because government intervention was at that time deemed a "moral hazard" – were experienced through defaults in all of that bank's swaps trades. As explained in the Lehman bankruptcy proceedings, that bank was a counterparty in over 930,000 swaps.[201] "[A]bout 6,000 [of those swaps] claims —totaling $60bn in losses — [i]nclude[ed] claims from about 40 of the largest U.S. banks."[202] Indeed, the swaps liabilities of many of Lehman's more than 3,000 subsidiaries in fifty foreign countries were all involved in the bankruptcy of Lehman's parent holding company.[203] To the extent that these contracts did not involve CDS or naked CDS, they certainly did involve, for example, interest rate, currency, foreign exchange, and commodity swaps.[204]

Lehman's inability to cover the indebtedness of the entirety of its swaps portfolio demonstrated the fragility of the swaps market as a whole – not just the weakness of the CDS or naked CDS market. If Lehman could not perform due to lack of reserves with regard to CDS or naked CDS, it could not perform throughout its swaps portfolio. With 6,000 Lehman counterparties experiencing losses as a result of Lehman's failure, it is clear that large-scale swaps

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200 *See* Johnson *in* ROOSEVELT INSTITUTE, *supra* note 169, at 117–33 ("America cannot end Too Big to Fail without derivatives reform.").

201 GuyLaine Charles, *OTC Derivative Contracts in Bankruptcy: The Lehman Experience*, 13 N.Y. BUS. L.J. 14, 16 (2009).

202 *Id.*; *see also* Patrick Fitzgerald, *Lehman Brothers to Pay another $3.8 Billion to Creditors*, WALL. ST. J (Sept. 29, 2016), https://www.wsj.com/articles/lehman-brothers-to-pay-another-3-8-billion-to-creditors-1475159586 (reporting on how the most recent distribution the investment bank made—its eleventh since filing for bankruptcy—will bring the total payout figure to more than $113.6 billion).

203 *See* Letter from Michael Greenberger, Prof., Univ. of Md. Carey Sch. of L., and George Waddington, Analyst, CHHS, Univ. of Md., to David A. Stawick, Sec'y, CFTC, RIN No. 3038-AD57 7 (Aug. 27, 2012) [Hereinafter Greenberger & Waddington Letter], http://www.michaelgreenberger.com/files/58709I-1.Greenberger.pdf.

204 *See id.*; Andrew Ackerman, *Court to Decide Fate of Lehman Contracts*, THE BOND BUYER (Dec. 15, 2008), *http://www.bondbuyer.com/issues/117_238/-297451-1.html* ("Though . . . [Lehman Brothers Holdings] does not provide specific numbers for each category of swap, derivatives market participants believe that roughly 20% to 30% of the contracts are municipal securities-based interest rate swaps.").

losses by any large U.S. bank swaps dealer would cause financial instability in all swaps obligations worldwide.

Moreover, the Lehman liquidators were required to engage in a huge legal battle with Lehman's many swaps counterparties over those counterparties (often heavily inflated evaluations of their losses from failed swaps transactions with Lehman) not just in CDS and naked CDS.[205] This exaggeration of amounts owed could only have been advanced in the non-transparent swaps market where swaps were not exchange-traded, and thus the value of swaps could not be readily determined by reference to well established exchange prices. The liquidators ultimately had to file lawsuits against many of these counterparties to cause them, once confronted with legal evidence of their puffing, to lower their bankruptcy claims to reflect market reality.

Finally, the Lehman liquidation also demonstrated that, even when the identical ISDA-mandated swaps contract provisions were being looked at by two different countries' courts (in Lehman's case, the U.S. courts and the U.K. courts), diametrically conflicting rulings from those countries could be reached.[206] A major single provision within the ISDA-inspired standardized swaps language critical to resolution of Lehman "bankruptcy [i]ssues [were] decided in [directly] conflicting fashion in London and New York . . . ."[207]

2. Bear Stearns Collapse Shows Financial Institution Swaps Interconnectedness

As further evidence of the interconnectedness of swaps counterparties within the full range of the worldwide swaps market, on April 3, 2008, then New York Federal Reserve President Timothy Geithner explained after the Bear Stearns' March 2008 collapse and corresponding Bear Stearns' rescue by JPMorgan Chase[208]:

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205 Megan Murphy & Anousha Sakoui, *Nomura Sued over Lehman Claims*, FIN. TIMES, Apr. 24, 2010, at 9.

206 Harry Wilson, *Lehman Brothers Investors Rank Ahead of Creditors, Rules Supreme Court*, TELEGRAPH (July 27, 2011), http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8666446/Lehman-Brothers-investors-rank-ahead-of-creditors-rules-Supreme-Court.html.

207 Stephen Luben, *Lehman Shows Trans-Atlantic Divide on Derivatives*, N.Y. TIMES (Jan. 7, 2011), https://dealbook.nytimes.com/2011/01/07/lehman-shows-trans-atlantic-divide-on-derivatives/?_r=0.

208 *See, e.g.*, Greg Farrell and USA Today, *JPMorgan, N.Y. Fed Step into Rescue Bear Stearns*, ABCNEWS, http://abcnews.go.com/Business/story?id=4454724 (last visited Apr. 12, 2017).

> "The sudden discovery by Bear's derivative counterparties that important financial positions they had put in place to protect themselves from financial risk were no longer operative would have triggered substantial further dislocation in markets. This would have precipitated a rush by Bear's counterparties to liquidate the collateral they held against those positions and to attempt to replicate those positions in already very fragile markets."[209]

Citing this quote, Warren Buffet concluded: "This is Fedspeak for [']We stepped in to avoid a financial chain reaction of unpredictable magnitude.['] In my opinion, the Fed was right to do so."[210]

3. AIG's Threatened Collapse and Systemic Interconnectedness

Of course, it was the very failure of Lehman on September 15, 2008, and, *inter alia*, the foreseeable cascading adverse and substantial adverse impacts Lehman's bankruptcy would cause to thousands of its swaps counterparties worldwide, that led the Federal Reserve and the Treasury to alter course one day after Lehman failed, to prevent AIG's bankruptcy by U.S. government intervention and then to recommend to Congress the bank bailouts.[211] These actions revealed to the world the correlation between and among unregulated swaps transactions of every kind and the "too-big-to-fail" phenomenon, *i.e.*, there were so many large swaps counterparties which would have failed because of swaps defaults that traditional bankruptcy solutions would have failed as well, thereby likely leading to the Second Great Depression.[212]

Moreover, the U.S. taxpayer bailouts that went into the front door of, for example, AIG to "save it" really went out the back door as payments to "save," *inter alia*, AIG's big U.S. bank holding swaps dealer counterparties.[213] As the report of the Congressional Oversight Panel

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[209] Letter from Warren E. Buffett, Chairman of the Board, Berkshire Hathaway Inc., to the Shareholders of Berkshire Hathaway Inc. (Feb. 27, 2009), http://www.berkshirehathaway.com/letters/2008ltr.pdf.

[210] *Id.*

[211] CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVT'S EXIT STRATEGY 53 (June 10, 2010), https://www.gpo.gov/fdsys/pkg/CPRT-111JPRT56698/pdf/CPRT-111JPRT56698.pdf.

[212] *See* Jill E. Sommers, Remarks Before the Capital Markets Consortium: Clearinghouse as Mitigators of Systematic Risk (Sept. 30, 2010), http://www.cftc.gov/PressRoom/SpeechesTestimony/CommissionerJillESommers/opasommers-10.html ("One of the lessons that emerged from the recent financial crisis was that institutions were not just "too big to fail," but also too interconnected through non-transparent swaps that the institutions did not effectively manage.").

[213] *See* Alexander Sellinger, *Backdoor Bailout Disclosure: Must the Federal Reserve Disclose the Identities of its Borrowers Under the Freedom of Information Act?*, 15 FORDHAM J. CORP. & FIN. L. 259, 260–61 (2009) (explaining the view that the billions used to bail out AIG was really a back door bailout to other counterparties who continued to gamble with the funds); Gretchen Morgenson, *At A.I.G.,*

("COP") on the AIG bailout made clear, billions of the taxpayer bailouts went 100 cents on the dollar to*, inter alia,* AIG's big U.S. bank holding company swaps dealers in their capacity as AIG's counterparties.[214] In this regard, COP observed as to AIG's derivatives book:

> "In the ordinary course of business, the costs of AIG's inability to meet its derivative obligations would have been borne entirely by AIG's shareholders and creditors . . . . But rather than sharing the pain among AIG's creditors[,] . . . the government instead shifted those costs in full onto taxpayers[.] The result was that the government backed up the entire derivatives market, as if these trades deserved the same taxpayer backstop as savings deposits and checking accounts. [E]very counterparty received exactly the same deal: a complete rescue at taxpayer expense."[215]

C. Other Prominent Twenty-First Century Financial Calamities Caused by Unregulated Swaps

Because the central thesis of this paper is that U.S. swaps dealers have created questionable loopholes to dodge the Dodd-Frank regimen to regulate swaps soundly, it is important to show that the 2008 financial crisis is not wholly a "one-off" event, which Dodd-Frank opponents have intimated to support relaxation of Dodd-Frank ten years after the meltdown. Other serious financial crises in the early 21st century demonstrate the way in which devastating economic instability and hardship can and will be caused when swaps are traded under lax regulatory regimes.

1. The Greek Financial Crisis

While the Greek financial crisis primarily focused on the financial instability of Greece itself and the European Union as a whole, the central cause of the Greek crisis has received scant attention.[216] In 2001, Greece found itself potentially in conflict with the European Union,

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Good Luck Following the Money, N.Y. TIMES, Mar. 15, 2009, at BU2 (revealing the counterparties that taxpayers bailed out with the funds allocated to A.I.G. "include Goldman Sachs, Merrill Lynch and two French banks, Calyon and Société Générale.").

214 CONG. OVERSIGHT PANEL, *supra* note 210, at 286.

215 *Id.* at 9.

216 Gregg Levine, *Did Wall Street enable the Greek Debt Crisis?* ALJAZEERA AMERICA (July 14, 2015), http://america.aljazeera.com/blogs/scrutineer/2015/7/14/did-wall-street-enable-greek-debt-crisis.html. *See* Robert Reich, *How Goldman Sachs Profited from the Greek Debt Crisis*, HUFF. POST (July 17, 2016), http://www.huffingtonpost.com/robert-reich/how-goldman-sachs-profite_b_7820794.html.

because that country had a 2.8-billion euro debt.[217] The Maastricht Treaty's deficit rules require all EU member states to show steady improvement in their finances after entering the EU.[218] However, the 2.8-billion-euro figure would have shown that Greece's national debt was, in fact, worsening.[219]

Wanting to mask that shortfall, Goldman Sachs was consulted by Greece, and that bank's "cure" involved it selling Greece a "cross currency swap," the first leg of which appeared immediately to erase 2% of Greek debt, bringing that country into seeming compliance with the EU's deficit rules.[220] Goldman Sachs received in excess of $500 million in fees for this swap arrangement.[221]

However, by 2005 the financial impact of the cross currency swap swung against Greece, leaving it with 5.1 billion-euro deficit, which was double the indebtedness Greece experienced before entering into the swap.[222] **(**If Goldman's over $500 million fee is included, Greece's financial shortfall *more* than doubled.) Therefore, it is not surprising that Greece rejected a new Goldman Sachs offer to engage in further financial engineering to make the larger 2005 indebtedness "disappear."

In what may have been a high irony, some important observers have criticized Mario Draghi, later to become President of the European Central Bank ("ECB"), for his connection to

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217 *Maastricht Treaty-not yet set in stone*, DEUTSCHE WELLE (June 2, 2016), http://www.dw.com/en/maastricht-treaty-not-yet-set-in-stone/a-37435390.

218 *See* André Sapir, *Europe After the Crisis: Less or More Role for Nation States in Money and Finance*, 27 OXFORD REV. ECON. P. 608 (2011).

219 Beat Balzli, *How Goldman Sachs Helped Greece to Mask its True Debt*, SPIEGEL ONLINE (Feb. 8, 2010), http://www.spiegel.de/international/europe/greek-debt-crisis-how-goldman-sachs-helped-greece-to-mask-its-true-debt-a-676634.html. *See* Robert Reich, *How Goldman Sachs Profited from the Greek Debt Crisis,* HUFF. POST (July 17, 2016), ,http://www.huffingtonpost.com/robert-reich/how-goldman-sachs-profite_b_7820794.html.

220 Jim Armitage and Ben Chu, *Greek Debt Crisis: Goldman Sachs Could be Sued for Helping Hide Debts When it Joined Euro*, INDEPENDENT (July 10, 2015), http://www.independent.co.uk/news/world/europe/greek-debt-crisis-goldman-sachs-could-be-sued-for-helping-country-hide-debts-when-it-joined-euro-10381926.html.

221 *Id.* (stating that Goldman was paid $500 million).

222 Nancy K. Humphries, *Goldman's Greek and Malaysian Deals,* HUFF. POST (last visited Apr. 4, 2017), http://www.huffingtonpost.com/nancy-k-humphreys/goldmans-greek-and-malays_b_7828700.html. *See* Robert Reich, *How Goldman Sachs Profited from the Greek Debt Crisis,* HUFF. POST (July 17, 2016), http://www.huffingtonpost.com/robert-reich/how-goldman-sachs-profite_b_7820794.html.

the Goldman Sachs-Greece deal.[223] Draghi, at roughly that time, was a Goldman Sachs officer responsible for developing business between Goldman Sachs and major European governments.[224] Draghi and the ECB later became highly critical of Greece, citing concerns about the sustainability of its debt, and they were proponents of the harsh austerity conditions imposed upon Greece as part of the bailouts.[225] Draghi, however, has denied any involvement in the deal between Greece and Goldman Sachs.[226]

The 2005 Greek debt imbalance, upon being made public by the Greek government, caused respected analysts to predict a 91% probability of a Greek default.[227] And, thus, three bailouts by the EU (the first two of which were joined by the IMF) were needed to prevent the financial collapse of Greece and possibly the EU itself. The EU bailouts were also accompanied by harsh EU austerity dictates for Greece as a condition of the bailouts, which has left Greece to this day a seriously financially destabilized nation.[228]

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223 Cynthia Kroet & Ivo Oliveira, *The Draghi Balance Sheet*, POLITICO (Nov. 4, 2015), https://www.politico.eu/article/mario-draghi-ecb-trichet-bank-financial-crisis-economy/.

224 *Professor Mario Draghi Joins Goldman Sachs*, GOLDMAN SACHS (Jan. 28, 2002), http://www.goldmansachs.com/media-relations/press-releases/archived/2002/2002-01-28.html.

225 Alessandro Speciale, *Draghi Signals Greek Debt Measures Not Enough for QE Inclusions*, BLOOMBERG (June 26, 2017), https://www.bloomberg.com/view/articles/2018-03-14/banks-try-to-do-less-pointless-work.

226 Kroet & Oliveira, *supra* note 222.

227 Katie Linsell and Sally Blakewell, *Credit Risk Gauges in Europe Rise by Most Since Lehman on Greece*, BLOOMBERG (June 29, 2015), https://www.bloomberg.com/news/articles/2015-06-29/credit-risk-surges-by-most-since-lehman-on-greek-euro-exit-risk.

228 *See* Katie Allen, *Greece Crisis Timeline—The Rocky Road to Another Bailout*, THE GUARDIAN (Aug. 20, 2015), https://www.theguardian.com/business/2015/aug/20/greece-crisis-timeline-rocky-road-another-bailout; COUNCIL ON FOREIGN RELATIONS, http://www.cfr.org/greece/timeline-greeces-debt-crisis/p36451 (last visited Apr.12, 2017) (stating that Greece received its first bailout on May 2, 2010. To avoid default, the International Monetary Fund and EU agreed to provide Greece with 110 billion euros ($146 billion) in loans over three years. In exchange, Greek Prime Minister Papandreou committed to austerity measures, including 30 billion euros in spending cuts and tax increases. Greece received its second bailout on February 21, 2012 worth 130 billion euros ($172 billion). The deal included a 53.5% debt write down—or "haircut"—for private Greek bondholders. In exchange, Greece was required to reduce its debt-to-GDP ratio from 160 percent to 120.5 percent by 2020. Greece and its private creditors complete the debt restructuring on March 9, 2012, the largest such restructuring in history. Later in 2012, Eurozone finance ministers and the IMF agree to a revised aid deal for Greece. The new plan allowed Greece to cut its debt-to-GDP ratio to 124 percent by 2020, rather than 120 percent, while committing it to bringing its debt levels "substantially below" 110 percent by 2022. On June 30, 2015, the Greek bailout expired; however, in August 2015 Greece received its third bailout. The Greek parliament adopted a suite of economic reforms as part of a new rescue package from the EU. In exchange for the 86 billion euro bailout, which is to be distributed through 2018, EU creditors required Greece to implement tax reforms, cut public spending, privatize state assets, and reform labor laws, among other measures. While the IMF participated in the previous bailouts, the organization refused to contribute additional funds until the creditors provide Greece "significant debt relief.").

Some analysts have suggested that Greece may have recently turned a corner on its finances and is on the road to recovery. While Greece has shown small signs of improvement,[229] this "sentiment" most likely reflects a "false dawn." Most observers still view Greece as a deeply troubled economy. Greece still struggles from, amongst other things, a weak private sector job market, weak innovation and export activity, and a persistently high consumption to GDP ratio.[230] Moreover, euro zone creditors have considered supplying Greece with yet a further bailout of 5.7 billion euros which is to serve "as a safety net" against possible future Greek defaults,[231] signaling that the EU, as well as many other creditors and experts, do not believe that Greece has fully emerged from its financial crisis.

2. The City of Detroit Bankruptcy

One of the primary causes of Detroit's declaration of bankruptcy in July 2013 was that city's massive financing costs associated with a series of Wall Street-driven interest rate swaps sold to Detroit in 2005 and 2006.[232] UBS AG ("UBS") and Bank of America Corporation's Merrill Lynch Capital Services executed those deals with Detroit supposedly to reduce Detroit's pension fund obligations.[233] The variable interest rate exposure on those pension fund obligations was exchanged under the swaps for fixed loan payments based on an interest rate of about 6.0% on a $1.4 billion pension debt plan.[234] In effect, Detroit was "hedging" against interest rate

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229 Griff Witte, *Battered for a Decade, Greece Feels an Unexpected Whiff of Revival as Europe Gains Strength*, WASH. POST (Mar. 8, 2018), https://www.washingtonpost.com/world/europe/after-a-prolonged-economic-crisis-a-greek-revival/2018/03/07/a9007ffe-1bcd-11e8-98f5-ceecfa8741b6_story.html?utm_term=.2b07a597fff6 (explaining that Greece finished 2017 with its highest annual growth since the financial crisis; the economy is forecasted to grow at a 2.5 percent rate in 2018, beating the forecast for the EU; and Greece is on the verge of exiting the bailouts).

230 Theodore Pelagidis & Michael Mitsopoulos, *The Inconvenient Truths About Greece*, BROOKINGS INST. (Mar. 1, 2018), https://www.brookings.edu/blog/up-front/2018/03/01/the-inconvenient-truths-about-greece/.

231 Francesco Guarascio & Jan Strupczewski, *Euro Zone to Unlock New Loans for Greece, Working on Debt Relief*, REUTERS (Mar. 12, 2018), https://www.reuters.com/article/us-eurozone-greece/euro-zone-to-unlock-new-loans-to-greece-working-on-debt-relief-idUSKCN1GO2DI; *Greece Says Gets Green Light for More Bailout Funds*, THE GUARDIAN (Mar. 2, 2018), https://guardian.ng/news/greece-says-gets-green-light-for-more-bailout-funds/.

232 David Sirota, *How Wall Street – Not Pensioners – Wrecked Detroit*, SALON.COM (Nov. 20, 2013), http://www.salon.com/2013/11/20/how_wall_street_not_pensioners_wrecked_detroit/.

233 *Id.*

234 Mary Williams Walsh, *'Safe Harbor' in Bankruptcy is Upended in Detroit Case*, N.Y. TIMES (Dec. 23, 2013), https://dealbook.nytimes.com/2013/12/23/safe-harbor-in-bankruptcy-is-upended-in-detroit-case/.

increases.[235] Of course, in the post-2006 era, interest rates dropped dramatically, but Detroit was left paying the much higher fixed swaps rate to its swaps dealer bank counterparties, rather than, in the absence of the swaps, paying the historically low variable rate it would have otherwise paid on its pension indebtedness.[236]

Of course, in the pre-Dodd-Frank era, these kinds of interest rate swaps were not exchange-traded. Detroit therefore could not unilaterally sell its damaging swaps on an exchange to minimize its foreseeable financial losses resulting from the dramatic drop in interest rates. Under the controlling ISDA Master Agreement, if Detroit terminated the swap before its expiration, all payments owed by Detroit under the term of the swap were immediately accelerated and a huge liquidated damage penalty would be assessed.[237] As is true of many ISDA-written swaps of that era for municipalities, the contractual length of Detroit's swaps was 30-years.[238] As a result, the bank swaps dealers began "demanding upwards of $250-300 million in swap termination payments" of this major city in economic distress in order to let Detroit out of the swaps scheme as it entered bankruptcy.[239]

In a typical bankruptcy proceeding, the bankrupt city's creditors would "have to 'take a haircut'."[240] However, ISDA had successfully lobbied Congress for a supposed "safe harbor" in

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235 *Id.*

236 *Id.*

237 *Id.*

238 *Were Detroit's Swaps Fair?*, BLOOMBERG (Jan. 27, 2014), https://www.bloomberg.com/view/articles/2014-01-27/were-detroit-s-swaps-unfair-; Thomas Gaist, *Wave of US Municipal Bankruptcies Caused by Wall Street Predatory Interest Rates, Not Pensions*, GLOBALRESEARCH (Jan. 8, 2014), http://www.globalresearch.ca/wave-of-us-municipal-bankruptcies-caused-by-wall-street-predatory-interest-rates-not-pensions/5364268.

239 David Sirota, *How Wall Street – Not Pensioners – Wrecked Detroit*, SALON.COM (Nov. 20, 2013), http://www.salon.com/2013/11/20/how_wall_street_not_pensioners_wrecked_detroit/.

240 *Id.*

the bankruptcy code that is even today quite controversial.[241] That bankruptcy provision, if enforced as ISDA reads it, requires payment of "100 cents on the dollar" for indebtedness under the swap before the bankruptcy code's traditional creditor "haircuts" are made.[242]

In the Detroit bankruptcy proceedings, however, the bankruptcy judge rejected "termination" settlements made between the bank swap dealers and Detroit — first for $230 million (*i.e.*, 75 percent of the debt) and then for $165 million (*i.e.*, 57 cents on the dollar) , respectively. The judge called the underlying swaps obligation to the banks "legally dubious."[243] As to the proposed $165 million settlement, the bankruptcy judge said: "It's just too much money."[244] An $85 million settlement was finally approved.[245] This result, affirmed on appeal, undercut substantially ISDA's "safe harbor" bankruptcy contentions.[246]

3. Jefferson County, Alabama (Birmingham) Bankruptcy

Like Detroit, many other cities suffered debilitating losses from poorly understood interest rate swaps transactions. For example, Jefferson County, Alabama, in which the city of Birmingham is located, went bankrupt because of supposedly sound interest rate swaps gone wrong. The county cited more than $4.2 billion in debt when it filed for bankruptcy in November 2011.[247] Jefferson County's debt skyrocketed throughout the early 2000s when bond deals to upgrade its sewer system were compromised by systemic corruption, including bribery and

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241 AM. BANKRUPTCY INST., COMM'N TO STUDY THE REFORM OF CHAPTER 11, 2012-2014 FINAL REPORT AND RECOMMENDATIONS 94-110 (2014).

242 *See* Walsh, *supra* note 233; *Hedges Against Risk may Complicate Bankruptcy*, LAW360 (Mar. 14, 2008), https://www.law360.com/articles/50211/hedges-against-risk-may-complicate-bankruptcy.

243 Addison Pierce, *Why Detroit's Good-Enough Swap Settlement Should Be Good Enough for the Court*, AM. U. BUS. L. REV., Jan. 4, 2014, http://www.aublr.org/2014/01/why-detroits-good-enough-swap-settlement-should-be-good-enough-for-the-court-2/.

244 Robert Snell, *Bankruptcy Judge Denies Detroit's Swaps Deal*, ROLAND MARTIN REPORTS, Jan. 16, 2014, http://rolandmartinreports.com/blog/2014/01/bankruptcy-judge-denies-detroits-swaps-deal/.

245 Addison Pierce, *Why Detroit's Good-Enough Swap Settlement Should Be Good Enough for the Court*, AM. U. BUS. L. REV., Jan. 4, 2014, http://www.aublr.org/2014/01/why-detroits-good-enough-swap-settlement-should-be-good-enough-for-the-court-2/.

246 *See generally*, *In re City of Detroit*, 524 B.R. 147 (Bankr. E.D. Mich. 2014), *appeal dismissed by, as moot In re City of Detroit*, No. 14-cv-14872, 2015 U.S. Dist. LEXIS 131174 (E.D. Mich. Sep. 29, 2015), *aff'd, rehearing denied by, rehearing, en banc, denied, Ochadleus v. City of Detroit (In re City of Detroit)*, 838 F.3d 792 (6th Cir. 2016).

247 *Jefferson County Emerges from Bankruptcy*, ASSOCIATED PRESS (Dec. 4, 2013), http://www.tuscaloosanews.com/news/20131204/jefferson-county-emerges-from-bankruptcy.

fraud charges related to municipal bond offerings and swap transactions, which led to twenty two criminal convictions.[248]

Jefferson Country began selling these sewer bonds in 1997 and within five years had raised $2.8 billion.[249] JPMorgan Chase advised the county to "refinance" the bonds using adjustable interest rate swaps, which hedged the adjustable rate obligations by swapping them for fixed rate interest payments to the bank swaps dealers.[250]

> "Jefferson County records show that the bonds provided the banks with $120 million in excessive fees with JPMorgan selling the county $2.7 billion of interest-rate swaps, Bank of America sold the county $373 million in swaps and Lehman Brothers sold the county another $190 million of swaps.[251]
>
> In 2008, the Jefferson Country interest rate swaps scheme crumbled as the fixed interest rate swaps payments under the swaps increased (while variable rates substantially decreased). Jefferson County's fixed monthly debt payment rose from $10 to $23 million.[252] The county was unable to meet this obligation when [p]ayments the county relied on under its swap agreements to cover the interest payments on its adjustable-rate bonds hit the skids when Moody's and Standard and Poor's cut the sewer bonds rating to just above 'junk'."[253]

The downgrade would have permitted Wall Street bank swap dealers to extricate themselves from these swap deals, while at the same time the county faced an additional billion dollars in swaps termination fees.[254] As the county's liabilities climbed ever higher, eventually eclipsing $4 billion, bankruptcy became its only viable option. At the time of its filing (before

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248 Melinda Dickinson, *Alabama County Files Biggest Municipal Bankruptcy*, REUTERS (Nov. 10, 2011), http://www.reuters.com/article/us-usa-alabama-jeffersoncounty-idUSTRE7A94CP20111110; *JPMorgan Paying $700 Million to Settle SEC Charges*, ASSOCIATED PRESS (Nov. 4, 2009), http://www.cleveland.com/business/index.ssf/2009/11/jpmorgan_paying_700_million_to.html.

249 Renee Parsons, *JP Morgan and the Largest Municipal Bankruptcy*, HUFF. POST (Mar. 15, 2012), http://www.huffingtonpost.com/renee-parsons/jp-morgan-and-the-largest_b_1347324.html; *Id*. Note that there was no competitive bidding on these bonds.

250 *Id*. The bank persuaded Jefferson County to refinance despite the fact that fixed rate financing offered the lowest municipal bond interest rates in more than three decades. *Id*.

251 *Id*. ("In exchange for $25 million cash, the county by then held $5.8 billion of interest-rate swaps, more than other county in the U.S."). In 2004, JPMorgan convinced the county that it could generate necessary capital through additional swaps deals with Bear Stearns ($1.5 billion) and Bank of America ($380 million).

252 *Id.*

253 *Id.*

254 *Id*.

Detroit's 2013 bankruptcy), Jefferson County's bankruptcy was the largest municipal bankruptcy in United States history.

Months of intense negotiations followed, and finally a settlement of the county's swaps obligations was approved. Under the settlement, the county agreed to pay its largest swaps creditors $1.84 billion, approximately 60% of what the swaps creditors claimed they were owed under*, inter alia*, swaps contract termination penalties.[255]

Further complicating this financial calamity, prior to its settlement with Jefferson County, JPMorgan Chase settled with the SEC over that regulator's charges the bank had made illegal payments to friends of public officials in Jefferson County to acquire municipal bond business.[256] Because of this, JPMorgan Chase was required by the SEC to grant significant concessions to the county in the county's bankruptcy settlement.[257] That accounted for JPMorgan Chase giving Jefferson County a 60% decrease in the amount the bank claimed the county owed in swaps termination costs. After finalizing that settlement, the county was able to emerge from bankruptcy in December 2013.

It is worth noting, however, that residents of the county later complained of inequitable treatment because "several of [the county's] elected officials went to prison . . . while no one from the banks was convicted of a crime."[258] Furthermore, the county was forced to lay off 1,000 employees, and many county residents watched their water/sewer service bills climb to up to $250 per month, and many were otherwise denied access to running water and forced to

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255 Steven Church, Margaret Newkirk & Kathleen Edwards, *Jefferson County, Creditors Reach Deal to End Bankruptcy*, BLOOMBERG (June 5, 2013), https://www.bloomberg.com/news/articles/2013-06-04/jefferson-county-reaches-deal-with-creditors-on-bankruptcy-exit. It is worth nothing that the county will pay $5 billion in interest over the next 40 years as it pays off the $1.8 billion settlement; *Jefferson County Emerges from Bankruptcy*, ASSOCIATED PRESS (Dec. 4, 2013), http://www.tuscaloosanews.com/news/20131204/jefferson-county-emerges-from-bankruptcy.

256 *Id*.; see, *e.g.*, Mary Williams Walsh, *A County in Alabama Strikes a Bankruptcy Deal*, N.Y. TIMES (June 4, 2013), https://dealbook.nytimes.com/2013/06/04/a-county-in-alabama-strikes-a-bankruptcy-deal/?_r=0; *JPMorgan paying $700 Million to Settle SEC Charges*, ASSOCIATED PRESS (Nov. 4, 2009), http://www.cleveland.com/business/index.ssf/2009/11/jpmorgan_paying_700_million_to.html. This settlement required JPMorgan Chase & Co.to a $25 million civil fine, $50 million payment to the county and forfeit $647 million in termination fees that it claimed the county owed on interest-rate swaps.

257 *See* Walsh, *supra* note 255.

258 *Id*.

share portable toilets.[259] JPMorgan Chase, for its part, did not post a single "losing quarter throughout the 2008 economic crisis."[260]

4. Other Problems with Unregulated Interest Rate Swaps Faced by Local Governments and University Systems

As one informed observer so aptly put it, these local government interest rate swaps engineered by the big U.S. bank holding company swaps dealers "[p]redictably, [were] a jackpot for Wall Street and their bankrolled politicians, but it was the opposite for [municipal] taxpayers."[261] For example, many public school systems, such as the University of California system, "lost tens of millions of dollars, and [are] set to lose far more, after making risky bets on interest rates on the advice of Wall Street bankers."[262] The *Financial Times* reported that "a number of [other universities] are caught up in dicey bond deals like the sort that sunk the city of Detroit[.]"[263]

One does not have to look far to see how so many public institutions were lulled into the belief by swaps dealers that they did not need to understand how these swaps worked. As the National Association for Pension Funds so aptly put it in its 2005 guidance ("Swaps Made Simple; What a Trustee Needs to Know"): As to "[l]ack of understanding[,] [pension t]rustees do not necessarily need to understand all of the detailed mechanics of how swaps work to use them effectively – much in the same way we do not need to understand the internal mechanics of a car to drive it. . . ."[264]

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259 Renee Parsons, *JP Morgan and the Largest Municipal Bankruptcy*, HUFF. POST (Mar. 15, 2012), http://www.huffingtonpost.com/renee-parsons/jp-morgan-and-the-largest_b_1347324.html.

260 *Id*.

261 David Sirota, *How Wall Street – Not Pensioners – Wrecked Detroit*, SALON.COM, Nov. 20, 2013, http://www.salon.com/2013/11/20/how_wall_street_not_pensioners_wrecked_detroit/.

262 Melody Petersen, *UC Lost Millions on Interest-Rate Bets*, ORANGE COUNTY REGISTER, Dec. 17, 2014, http://www.ocregister.com/articles/university-602769-interest-rate.html; Thomas Gaist, *Wave of US Municipal Bankruptcies Caused by Wall Street Predatory Interest Rates, Not Pensions*, GLOBALRESEARCH, Jan. 8, 2014, http://www.globalresearch.ca/wave-of-us-municipal-bankruptcies-caused-by-wall-street-predatory-interest-rates-not-pensions/5364268.

263 Patrick Jenkins, *The Tangled Web of Gary Cohn, Goldman Sachs and Glass-Steagall*, FIN. TIMES (Apr. 10, 2017), https://www.ft.com/content/1cdae6d8-1b90-11e7-bcac-6d03d067f81f.

264 NAT'L ASS'N OF PENSION FUNDS, SWAPS MADE SIMPLE: WHAT A TRUSTEE NEEDS TO KNOW 10 (2005) (bold in original) (italics added), https://www.actuaries.org.uk/documents/swaps-made-simple-what-trustee-needs-know.

If cars crashed as often as interest rate swaps do for these municipal and public counterparties, drivers might be inclined to learn more about their cars' "internal mechanics." The above quoted "assurance" to swaps end users, however, represents a key reason that swaps blow up on public entities with harsh financial consequences for, *inter alia*, taxpayers and pensioners.[265]

5. The London Whale

After Dodd-Frank passed in July 2010, but before that law went into effect,[266] a JPMorgan Chase derivatives trader, Bruno Iksil, who was famously known as the "London Whale," working out of a JPMorgan Chase London branch, unsuccessfully engaged in extremely risky unregulated CDS swaps trades. Those trades resulted in that bank ultimately booking a $6.2 billion loss – a sum that would have sunk many other large financial institutions without JP Morgan Chase's capital reserves.

Investigations into the "London Whale's" conduct demonstrated that internal bank risk limits were exceeded by Iksil more than 300 times; two sets of books were kept to conceal the misconduct; and internal bank supervision and U.K. financial regulatory oversight were nearly non-existent.[267] It is true that JPMorgan Chase was ultimately subject to fines and damages under a number of settlements arising from the London Whale episode,[268] but it was fortunate

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265 *Id.*

266 *With Effective Date of Dodd-Frank Derivatives Provisions Looming, SEC Gives Guidance on Title VII*, JIM HAMILTON'S WORLD OF SEC. REG. (June 18, 2011), http://jimhamiltonblog.blogspot.com/2011/06/with-effective-date-of-dodd-frank.html. While Dodd-Frank was enacted on July 21, 2010, its effective date was 60 days after a final rule was published in cases where the statute required a rule. Almost all of Title VII's swaps provisions require a rule.

267 *See generally JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses: Hearing before the Permanent Subcomm. On Investigations of the S. Comm. on Homeland Sec and Gov't Affairs*, 113th Cong. (2013), https://www.gpo.gov/fdsys/pkg/CHRG-113shrg85162/pdf/CHRG-113shrg85162.pdf; The London Whale Escapes and Blames His Bosses: Who Is Responsible for the $6.2 Billion Loss?, WGL-ACCTALERT VOL 11 NO 175; Heidi Mandanis Schooner, Big Bank Boards: The Case for Heightened Administrative Enforcement, 68 Ala. L. Rev. 1011, 1012 (2017).

268 Patricia Hurtado, *The London Whale*, BLOOMBERG, Feb. 23, 2016, https://www.bloomberg.com/quicktake/the-london-whale; Jonathan Stempel, *U.S. to Drop Criminal Charges in 'London Whale' Case*, Reuters (July 21, 2017), https://www.reuters.com/article/us-jpmorgan-londonwhale/u-s-to-drop-criminal-charges-in-london-whale-case-idUSKBN1A62M9; Jane Croft and Caroline Binham, *Ex-JPMorgan Trader Loses FCA Fight Linked to 'London Whale' Case*, FIN. TIMES (Jan. 31, 2018), https://www.ft.com/content/766e70d6-067a-11e8-9650-9c0ad2d7c5b5; Suzi Ring, *London Whale's `Minnow' Is Last Hurdle in FCA Identity Fights*, BLOOMBERG (Jan. 16, 2018), https://www.bloomberg.com/news/articles/2018-01-16/london-whale-s-minnow-is-last-hurdle-in-fca-identity-fights ("The regulator returned to court Tuesday to challenge a previous decision won by former JPMorgan trader Julien Grout, who said he was identifiable in the bank's London Whale penalty notice, which accompanied a 138 million-pound ($189 million) settlement with the bank in 2013. JPMorgan was fined more than $1 billion by U.S. and U.K. regulators after Grout's boss Bruno Iksil, nicknamed the London Whale for his large bets, incurred $6.2 billion in losses at the lender.").

that the damage done by this single rogue trader was not more extensive or conducted more extensively (with resulting even larger losses) by a group of rogue traders within the bank.

IV. Worrisome Financial Calamities on the Horizon Caused by Growing Massive Consumer Debt Defaults.

A. Growing New Defaults on Trillions of Dollars of Consumer Debt

As of this writing, there is a general popular consensus that the American economy is booming because of low unemployment,[269] recent growth in GDP, and the touted stimulus impact of the Tax Cuts and Jobs Act of 2018.[270] In this regard, testifying before the House Financial Services Committee, Jerome Powell, the new Chair of the Federal Reserve, stated: "The next couple of years look quite strong. I would expect the next two years to be good years for the economy."[271] On March 1, 2018, Powell again maintained that the country's economic outlook remained positive in remarks submitted to the Committee on Banking, Housing, and Urban Affairs.[272]

However, despite Chairman Powell's recent remarks, there are sophisticated assessments by respected observers that the present-day economy has many of the characteristics of the seemingly thriving economy prior to the 2008 meltdown, when economic optimism reigned.[273] A recent study contends "the same problems that led to the biggest financial market

269 *But see* Poduk et al., *supra* note 91 ("[While employment has risen . . . about a fifth of the U.S. jobs are in occupations where the median income is below the federal poverty line. And median household income is barely above its 2008 level adjusting for inflation.").

270 *See*, *e.g.*, Ben Casselman, *Up, up, up Goes the Economy. Here's What Could Knock it Down*, N.Y. TIMES (Mar. 20, 2018), https://www.nytimes.com/2018/03/20/business/economy/economy-recovery.html ("Unemployment is low, job creation is strong and the overall economy seems to be gaining momentum, not losing it. Most economists expect the expansion to continue well into next year, which would make it the longest ever.").

271 Heather Long, *New Fed Chair Jerome Powell Sees Little Risk of a Recession*, WASH. POST (Feb. 27, 2018), https://www.washingtonpost.com/news/wonk/wp/2018/02/27/fed-chairman-in-public-debut-vows-to-prevent-overheated-u-s-economy/?utm_term=.c3ba7f4c7ce8.

272 *Semiannual Monetary Policy Report to the Congress*, 115th Cong. (2018) (statement of Jerome H. Powell, Chairman of the Board of Governors of the Federal Reserve System).

273 *See* Steven Pressman & Robert H. Scott, *Recent Stock Market Sell-Off Foreshadows a New Great Recession*, SALON (Mar. 25, 2018, 1:30 PM), https://www.salon.com/2018/03/25/recent-stock-market-sell-off-foreshadows-a-new-great-recession_partner/ (discussing parallels between the conditions that led to 2008's recession and characteristics of the present-day economy). *See also*, Pearlstein, *supra* not 58; Gillian Tett, *"The corporate debt problem refuses to recede; Non-financial leverage is higher today than it was before the crisis,"* Financial Times (February 8, 2018), https://www.ft.com/content/ceb8d8ee-0b57-11e8-8eb7-42f857ea9f09; Heejm Kim, "Jim Rogers Says Next Bear Market Will Be Worset in His Life, Bloomberg (February 8, 2018), //www.bloomberg.com/news/articles/2018-02-09/jim-rogers-says-next-bear-market-will-be-worst-in-his-lifetime; John Authers, "*The market parallels with 2007*," Financial Times (February 6, 2018), http://www.moneywatch.us/authers-note-the-market-parallels-with-2007/ ("I hate to admit this, but I think I have found a good historical parallel for what is happening in the markets [today]. And, it is with the spring and summer of 2007, on the eve

meltdown since the Great Depression are alive and well today."[274] Specifically, that research demonstrates that the "rosy-looking stats" of lower unemployment and an increase in median household income conceal the same serious issues that precipitated the 2008 recession, namely: "excessive consumer debt (relative to income) and unaffordable housing."[275]

The troubling implications of this research have been repeatedly corroborated by the reports of other respected economic commentators. *Fortune* notes that outstanding non-mortgage consumer credit is currently nearing $4 trillion – a 45% increase from 2008.[276] At over a trillion dollars, credit card debt in the U.S. "has reached a seven-year high . . . ." Internationally, "nonfinancial corporate debt increased to 96% of global GDP between 2011 and 2017, with some 37% of global companies now deemed to be 'highly leveraged,''" (meaning they have a debt-to-earnings ratio above five-to-one) up from 32% in 2007 . . . ."[277] In the U.K., concern over the rapid growth of consumer debt has prompted the leading U.K. financial regulator to waive or reduce credit card fees and interest for certain consumers caught in persistent debt.[278] Designed to help consumers, the rule will have the corresponding impact of limiting funds to lenders who are experiencing these worrisome defaults, including demonstrated "negative repercussions for sub-prime . . . credit card securitizations."[279]

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of the [2008] credit crisis."); Nishant Kumar & Suzy White, "*Greenlight's Einhorn Says Issues That Caused the Crisis Are Not Solved*," Bloomberg (November 15, 2017), //www.bloomberg.com/news/articles/2018-02-09/jim-rogers-says-next-bear-market-will-be-worst-in-his-lifetime. Even Carl Icahn has said that today derivatives are "risky, often completely misunderstood" financial instruments. Cezary Podkul, *Ten Years After the Crisis*, Wall Street Journal (Mar. 27, 2018), http://graphics.wsj.com/how-the-world-has-changed-since-2008-financial-crisis/.

274 Pressman & Scott, *supra* note 273.

275 *Id.*; *See* Poduk et al., *supra* note 91.

276 Daniel J. Arbess, *The Economy Looks Good Today, But the Next Debt Crisis is on the Horizon*, FORTUNE (Feb. 28, 2018), http//fortune.com/2018/02/28/debt-crisis-jerome-powell-federal-reserve-testimony.

277 *Id* See also, e.g. Pearlstein, *supra* note 58. Pearlstein says there: ""Now, 12 years [after the 2008 crisis], it's happening again. This time, however, it's not households using cheap debt to take cash out of overvalued homes. Rather, it is giant corporations using cheap debt –corporate debt—to record levels. . . .And, once again, they are diverting capital from productive long-term investment to further inflate a financial bubble – this one in corporate stocks and bonds – that, *when it bursts, will send the economy into another recession*." *Id*. (emphasis added*.)*

278 Caroline Binham, *FCA Overhauls Rules on Credit Card Charges for Struggling Debtors*, FIN. TIMES (Feb. 27, 2018), https://www.ft.com/content/f290ac8e-1baa-11e8-aaca-4574d7dabfb6.

279 Bob Thornhill, *New FCA Rules May Hit Credit Card Profitability*, GLOBAL CAPITAL (Feb. 27, 2018), https://www.globalcapital.com/article/b173ptjpclz6v5/new-fca-rules-may-hit-credit-card-profitability; *see also* Adam Samson, *US Midwest Factory Sector Gauge Skids to Lowest Level in a Year*, FIN. TIMES (Mar. 29, 2018), https://www.ft.com/content/c1dbb92a-3357-11e8-ac48-

Ultimately, the same financial architecture that surrounded the housing mortgage crisis (almost certainly including "naked" credit default swaps) has been replicated in the three key areas where debt is growing at a troubling rate: defaults in student loans, auto loans, and credit card debt. There are even recent reports that subprime mortgage backed securities "have roughly doubled in the first [2018] quarter from a year earlier, as investors lapped up assets blamed for bringing the global financial system to the brink of collapse a decade ago."[280] As was reported in the *Wall Street Journal* on the tenth anniversary of Bear Stearns crisis: "A decade after risks associated with financial engineering nearly brought the economy to its knees, sales of similar products are ticking higher."[281]

B. Rising Defaults on Student Debt

As of this writing, there is hardly a day that goes by without a chilling warning that defaults on student loans provides "an eerie echo of the housing crisis."[282] As the *Wall Street Journal* just observed: "Some worry student debt, rising for years, could figure in the next credit crisis."[283]

> "[O]ver the past [ten] years the amount of student loan debt in the US has grown by 170%, to a whopping $1.4 [trillion] – more than car loans, or credit card

10c6fdc22f03 (showing that manufacturing in the Midwest grew at the slowest rate in over a year and the American economy grew "at a roughly 1.8 percent annualized rate, down sharply from an initial forecast of 4.2 percent, and a peak of 5.4 percent.").

280 Ben McLannahan & Joe Rennison, *US Subprime Mortgage Bonds Back in Fashion*, FIN. TIMES (Mar. 29, 2018), https://www.ft.com/content/6478a8d6-32c3-11e8-b5bf-23cb17fd1498.

281 *See* Poduk et al., *supra* note 91.

282 Rana Foroohar, *The US College Debt bubble is Becoming Dangerous*, FIN. TIMES (Apr. 9, 2017), https://www.ft.com/content/a272ee4c-1b83-11e7-bcac-6d03d067f81f.; Judith Scott-Clayton, *The Looming Student Loan Default Crisis is Worse than We Thought*, BROOKINGS (Jan. 11, 2018), https://www.brookings.edu/research/the-looming-student-loan-default-crisis-is-worse-than-we-thought/; Matthew Michaels, *More People than Ever are Defaulting on Student Loans – and it Could Put the US Economy at Risk*, BUS. INSIDER (Dec. 14, 2017), http://www.businessinsider.com/student-loan-default-puts-economy-at-risk-2017-12; John Authers, *Authers' Note: The Market Parallels with 2007*, FIN. TIMES (Feb. 5, 2018), https://www.ft.com/content/beaa0c4a-0af1-11e8-8eb7-42f857ea9f09.

283 *See* Poduk et al., *supra* note 91.

debt."[284] As one financial regulator has warned that 'since 2008 we have basically swapped a housing debt bubble for a student loan bubble.'"[285]

William Dudley, "[then-]president of the New York Federal Reserve Bank [has] sounded the alarm [about] the student debt crisis," stating that:

> "students now leave school owing on average $34,000[,] up 70 percent from a decade ago . . . . [L]oan delinquency climbed to 11.2 per cent in the last quarter of 2016, the highest rate for all types of household debt . . . . More than one in ten borrowers are at least 90 days behind in repaying their student debt[.]"[286]

Again, inhering in the student loan debt crisis are the same financial engineering instruments present during the 2008 crisis, *e.g.*, student loan asset-backed securities, collateralized debt obligations,credit default swaps and naked credit default swaps.[287] Many of these instru-

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[284] *Id.*; Nishant Kumar & Suzy Waite, *Greenlight's Einhorn Says Issues That Caused the Crisis Are Not Solved*, BLOOMBERG MKT. (Nov. 15, 2017), https://www.bloomberg.com/news/articles/2017-11-15/greenlight-s-einhorn-says-issues-that-caused-crisis-not-solved-ja1cw3ws; Jody Laurie & Lisa Abramowicz, *How America's Consumer Debt Threatens Credit Markets*, BLOOMBERG DAYBREAK: AM. (Dec. 20, 2017), https://www.bloomberg.com/news/videos/2017-12-20/how-u-s-consumer-debt-threatens-credit-markets-video; Victor Dergunov, *America's Impending Debt Crisis*, SEEKING ALPHA (Nov. 3, 2017), https://seekingalpha.com/article/4120000-americas-impending-debt-crisis; Chris Markowski, *America's $1 Trillion in Credit Card Debt is Terrible News for Our Future*, THE HILL (Aug. 25, 2017), http://thehill.com/blogs/pundits-blog/finance/347973-americas-1-trillion-in-credit-card-debt-is-terrible-news; Wolf Richter, *America's Debt is Surging, and Some of the Riskiest Borrowers are Struggling to Pay Back*, BUS. INSIDER (Nov. 15, 2017), http://www.businessinsider.com/consumer-debt-surges-and-subprime-auto-delinquencies-rise-2017-11; Tyler Durden, *US Consumers Tap Out: Credit Card Defaults Surge To 4 Year High And It's Getting Worse*, ZEROHEDGE (Apr. 26, 2017, https://www.zerohedge.com/news/2017-04-26/us-consumers-tap-out-credit-card-defaults-surge-4-year-high-and-its-getting-worse; Jessica Dickler, *Credit Card Debt Hits a Record High*, CNBC (Jan. 23, 2018), https://www.cnbc.com/2018/01/23/credit-card-debt-hits-record-high.html; Michelle Singletary, *Consumer Debt is at a Record High. Haven't We Learned?*, WASH. POST (Aug. 12, 2017), https://www.washingtonpost.com/business/us-consumer-debt-is-at-a-record-high-havent-we-learned/2017/08/11/5c7bee6e-7e13-11e7-a669-b400c5c7e1cc_story.html?utm_term=.0242cf78f1db; John A. Byrne, *Americas' Household Debt has Surged by $605B this Year*, N.Y. POST (Nov. 26, 2017), https://nypost.com/2017/11/26/new-yorkers-household-debt-has-surged-by-605b-this-year/; Nick Clements, *Consumer Debt Reaches New Peak: Will Losses Follow?*, FORBES (Aug. 18, 2017), https://www.forbes.com/sites/nickclements/2017/08/18/consumer-debt-reaches-new-peak-will-losses-follow/#6f4cd4a41849; Alistair Gray, *U.S. Banks Suffer 20% Jump in Credit Card Losses*, FIN. TIMES (Jan. 21, 2018), https://www.ft.com/content/bafdd504-fd2c-11e7-a492-2c9be7f3120a; Ben McLannahan, *Debt Pile-Up in US Care Market Sparks Subprime Fear*, FIN. TIMES (May 30, 2017), https://www.ft.com/content/bab49198-3f98-11e7-9d56-25f963e998b2; Ben McLannahan, *US Bank Derivatives Books Larger Since Rescue of Bear Sterns*, FIN. TIMES (Mar. 16, 2018), https://www.ft.com/content/201bce0c-289b-11e8-b27e-cc62a39d57a0.

[285] Alex Scaggs, *Triple B Risks Lurking in the US Credit Market*, FIN. TIMES (Mar. 22, 2018), https://www.ft.com/content/e48dec48-2ce2-11e8-a34a-7e7563b0b0f4.

[286] Eric Pianin, *America's Student-Loan Debt Reaches $1.3 Trillion (and It's Still Climbing)*, FISCAL TIMES (Apr. 5, 2017), https://www.inc.com/the-fiscal-times/student-loan-debt-1-trillion.html.

[287] *Attended A Public College? Don't Pay Your Federal Loans*, DAILY KOS (June 3, 2015), https://www.dailykos.com/stories/2015/6/3/1390122/-Attended-A-Public-College-Don-t-Pay-Your-Federal-Loans; Raúl Carrillo, *How Wall Street Profits Form Student Debt*, ROLLING STONE (Apr. 14, 2016), https://www.rollingstone.com/politics/news/how-wall-street-profits-from-student-debt-20160414; Rachel L. Ensing, *SecondMarket to Launch Student-Loan Securities Platform*, WALL ST. J. (Mar. 1, 2013), https://www.wsj.com/articles/SB10001424127887323978104578334342724776724; Larry Doyle, *Are Student Loans an Impending Bubble? Is Higher Education a Scam?*, BUS. INSIDER (Apr. 26, 2011), http://www.businessinsider.com/are-student-loans-an-impending-bubble-is-higher-education-a-scam-2011-5; Joe Rennison, *Investors Pour Back into Crisis-Era Credit Product*, FIN. TIMES (Apr. 23, 2017), https://www.ft.com/content/c4d815b2-86bc-11e7-bf50-e1c239b45787; COMMODITY FUTURES LAW REPORTS 1052,

ments were executed before the effective date of Dodd-Frank so that that statute's swaps requirements did not apply.[288] However, even if executed after the effective date of Dodd-Frank, the U.S. bank swap dealers have created the new loopholes identified in this paper that now can remove these instruments from Dodd-Frank's swaps protections at those swaps dealers' discretion.[289]

C. Rising Defaults on Auto Loans

What is true of the student loan market is also now true with auto loans, especially subprime auto loans. As was recently reported in *Forbes*:

> "Research from Experian, a credit firm, shows that the average duration of new car loans is at an all-time high of 5.5 years – with 25% of loans extending for 6-7 years, and some lasting 8 years or longer. The number of auto loans outstanding with subprime borrowers was 23% of the total in 3Q 2014. Increasingly those subprime borrowers are falling behind on their payments. More than 2.6% of borrowers who took out loans in the first quarter of 2014 had missed at least one monthly payment by November – the highest level of early trouble since 2008, when delinquencies rose above 3.0%. For borrowers with weak credit scores the delinquency rate was 8.4%."[290]

Similarly, a report on auto loans broadcast on *CNBC* showed:

"[A]n increasing portion of those loans is of the subprime—or, based on the borrower's credit history, more likely to default—variety. Through the middle of 2014, about 29 percent of all the securities based on auto loans to individuals were classified subprime, a level 15 percent higher

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Comm. Fut. L. Rep. P 5969704 ("estimated notional value of the U.S. swaps markets was $243 trillion in 2017, a 211 percent increase over the prior year").

288 *See infra* note 299 and accompanying text.

289 *See* SULLIVAN & CROMWELL LLP, TABLE C: EFFECTIVE DATES OF PRINCIPAL DODD-FRANK PROVISIONS, available at https://www.sullcrom.com/files/upload/Effective-Dates-of-the-Principal-Provisions-of-Dodd-Frank.pdf (last visited Apr. 5, 2018).

290 Michael Lingenheld, *The Next Subprime Crisis, Auto Loans, Won't End Well*, FORBES (Jan. 28, 2015), https://www.forbes.com/sites/michaellingenheld/2015/01/28/the-next-subprime-crisis-auto-loans/; Cooper Levey-Baker, *Do Rising Car Loan Defaults Signal a Precarious Economy?*, SARASOTA (Feb. 2, 2018), https://www.sarasotamagazine.com/articles/2018/2/2/precarious-economy ("Is the rise in delinquencies a sign of the debt bubble about to pop, like the housing market 10 years ago? Halliburton notes that delinquency rates are "creeping up," not "exploding," and warns against doomsday predictions, and the Federal Reserve suggests that the expansion of the subprime auto loan market may have a "muted" effect on the overall financial sector. But auto loans do make up a significant chunk of American debt. Total household debt rose to almost $13 trillion last year; $1.2 trillion of that was in auto loans, trailing only mortgage debt and student loan debt.").

than during the same period last year, according to figures from Standard & Poor's."[291] *Forbes* therefore reported:

> "[S]ales of US subprime auto ABS [Asset-Backed Securities] totaled more than $17.4 billion in 2014, after a record $22 billion were sold in 2013. Auto lenders have even started offering [auto loan asset backed securities] with a 'prefunding' feature that effectively packages securitized bundles of auto loans before they've even been made. While that might sound crazy and reminiscent of 2008, easier lending standards have been a big driver of vehicle sales that continue to beat expectations. The head of Honda's US sales recently warned that competitors are doing 'stupid things' to gain an advantage."[292]

Taking all these factors of the auto loan debt infrastructure into account, a Bloomberg report concluded:

> "[Recently], it appeared the chickens had come home to roost for some subprime auto lenders and investors, with Fitch Ratings warning that delinquencies in subprime car loans had reached a high not seen since October 1996. The number of borrowers who were more than 60 days late on their car bills in February rose 11.6 percent from the same period a year ago, bringing the delinquency rate to a total 5.16 percent, according to the credit rating company."[293]

Again, as the above quotes demonstrate and as is true of student loan and credit card indebtedness, the auto loans financial infrastructure mimics the failed financial engineering created in the mortgage markets leading up to the 2008 financial crash.

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[291] Kate Kelly, *New Debt Crisis Fear: Subprime Auto Loans*, CNBC (Oct. 1, 2014, 4:59 PM), https://www.cnbc.com/2014/10/01/new-debt-crisis-fear-subprime-auto-loans.html.

[292] Michael Lingenheld, *The Next Subprime Crisis, Auto Loans, Won't End Well*, FORBES (Jan. 28, 2015), https://www.forbes.com/sites/michaellingenheld/2015/01/28/the-next-subprime-crisis-auto-loans/

[293] Tracy Alloway, *This is what's Going on Beneath the Subprime Auto-Loan Turmoil*, BLOOMBERG (Mar. 21, 2016), https://www.bloomberg.com/news/articles/2016-03-21/this-is-what-s-going-on-beneath-the-subprime-auto-loan-turmoil.

D. Rising Defaults on Credit Card Debt

On August 7, 2017, Bloomberg reported that "U.S. consumer credit-card debt just passed an ominous milestone, beating a record set just before the global financial system almost collapsed in 2008."[294] Credit card debt reached an all-time high in June 2017 as the Federal Reserve valued outstanding credit card loans at $1.02 trillion.[295] Accompanying this record high of outstanding debt has been substantial losses sustained by banks. In 2017, "[t]he big four US retail banks [Citigroup, JPMorgan Chase, Bank of America, and Wells Fargo] sustained a near 20 per cent jump in losses from credit cards . . . , raising doubts about the ability of consumers to fuel economic expansion."[296] Together, Citigroup, JPMorgan Chase, Bank of America, and Wells Fargo lost $12.5 billion from credit card loans in 2017.[297] Relaxing approval standards, credit card issuers have aggressively attempted to attract customers and promote spending through monetary incentives such as bonuses and cashback.[298] Data indicates that card issuers have been largely successful as, "[c]ustomers opened about 110 million new credit card accounts in 2016. That's roughly 50 percent higher than 2010 and higher than any single year since 2007."[299] Together, the rapid increase of new credit card lines and the record high of defaults on credit card loans indicate a troubling trend that consumers are vastly spending beyond their means.

E. Future Economic Chaos

It bears repeating that defaults now occurring across the consumer spending economy mirror the defaults on debt preceding the mortgage meltdown. However, it is not just the defaults that are worrisome. It is the fact that the financial infrastructure that magnified the 2008

[294] Jennifer Surane, *U.S. Credit-Card Debt Surpasses Record Set at Brink of Crisis*, BLOOMBERG (Aug. 7, 2017, 6:09 PM), https://www.bloomberg.com/news/articles/2018-04-03/manhattan-home-sales-tumble-most-since-2009-as-buyers-push-back.

[295] *Id.*

[296] Alistair Gray, *US Banks Suffer 20% Jump in Credit Card Losses*, FIN. TIMES (Jan. 21, 2018), https://www.ft.com/content/bafdd504-fd2c-11e7-a492-2c9be7f3120a.

[297] *Id.*

[298] Robert Harrow, *What Consumers Can Expect From Credit Card Issuers in 2018*, FORBES (Jan. 29, 2018, 11:34 AM), https://www.forbes.com/sites/robertharrow/2018/01/29/what-consumers-can-expect-from-credit-card-issuers-in-2018/#39bc16f4672d.

[299] Herb Weisbaum, *Americans Have More Credit Cards – and More Debt, Says CFPB*, NBCNEWS (Dec. 28, 2017, 7:35).

financial meltdown has been built up around these three forms of debt as well. Through the new loopholes to Dodd-Frank swaps regulation identified in this paper, the major U.S. bank holding company swaps dealers have engineered a way to evade Dodd-Frank's regulations at will. Consequently, if a systemic break were to occur because of cascading and increasing student, auto, and/or credit card loan defaults and in swaps associated thereto, the economic chaos and harm of the 2008 financial meltdown may very well be repeated, as will the fact that the largest U.S. bank holding companies will then once again seek a multi-trillion dollar taxpayer bailout to avoid a Second Great Depression.

V. Dodd-Frank's Solutions for Stabilizing the Swaps Market

On July 21, 2010, President Barack Obama signed Dodd-Frank into law.[300] Dodd-Frank transformed the regulation of swaps by requiring generally that swaps be subject to clearing and, if cleared, by transparency through exchange-like trading, including capital, collateral or margin requirements, and checks on swaps dealers anti-competitive and ethical behavior. [301]

The Act first requires that all "swap dealers" ("SD" or "SDs") and "major swap participants" ("MSP" or "MSPs") register with the appropriate banking prudential regulators, the CFTC, and/or, if equity swaps are involved, the SEC.[302] A swap dealer is an entity that (1) holds itself out as such, (2) makes a market in swaps, (3) regularly enters into swaps for its own account in the ordinary course of business, or (4) engages in activity generally recognized in the trade as dealing in swaps.[303] Major swap participants are entities that are not swap dealers and

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300 The Dodd–Frank Wall St. Reform and Consumer Prot. Act, Pub. L. No. 111–203, 124 Stat. 1376 (July 21, 2010); Brady Dennis, *Obama Ushers in New Financial Era; Landmark Law is Signed President Says Work Still Lies Ahead for Regulators*, WASH. POST, July 22, 2010, at A13.

301 BAIRD WEBEL ET AL., CONG. RESEARCH SERV., R40975, FIN. REGULATORY REFORM AND THE 111TH CONG. 12 (2010), http://assets.opencrs.com/rpts/R40975_20100601.pdf ("H.R. 4173 . . . mandate[s] reporting, centralized clearing, and exchange-trading of OTC derivatives . . . . The bill[] require[s] regulators to impose capital requirements on swap dealers and "major swap participants.").

302 *Id.*; Dodd-Frank Wall St. Reform & Consumer Prot. Act, Pub. L. No. 111-203, § 731(a), 124 Stat. 1376, 1703 (2010). In the case of U.S. bank holding companies, Dodd-Frank gives the appropriate prudential regulators jurisdiction for capital and margin requirements if the bank is a swaps dealer or a major swap participant. Douglas Landy, Melissa Ferraro & James King, *United States: "Are You My Mother?": Which Agency Governs What Swap Entity Under the Margin Rules for Non-Cleared Swaps?*, MONDAQ (May 9, 2016), http://www.mondaq.com/unitedstates/x/489242/Commodities+Derivatives+Stock+Exchanges/Are+You+My+Mother+Which+Agency+Governs+What+Swap+Entity+Under+The+Margin+Rules+For+NonCleared+Swaps. Non-bank subsidiaries of U.S. bank holding companies are governed entirely by the CFTC or SEC, depending on the nature of the swap for all swaps regulation, including capital and margin.

303 Dodd-Frank Wall St. Reform & Consumer Prot. Act, Pub. L. No. 111-203, § 721(a), 124 Stat. 1376, 1658 (2010).

(1) maintain a substantial position in swaps, excluding transactions used to hedge commercial risk, (2) create substantial counterparty exposure that could undermine the banking system or financial markets, or (3) are highly leveraged, but not subject to federal prudential bank regulators' capital requirements, and (4) maintain a substantial position in swaps.[304] For purposes of this paper, all relevant U.S. financial entities focused on herein are swaps dealers.

At present, the threshold for SD registration with the CFTC is the conducting of many billions of dollars in swaps trades per year.[305] Registered SDs must disclose any material risks of swaps and any material incentives or conflicts of interests.[306] In addition, they must meet capital and margin (or collateral) requirements and conform to business conduct rules, including those related to fraud and market manipulation, that are set by the regulators (while clearing organizations and exchanges can supplement these federal regulator requirements).[307] Dodd-Frank also requires that swaps transactions be reported to federal regulators.[308]

The CFTC conceptually separates its regulation of SDs into "Entity-Level" Requirements and "Transaction-Level" Requirements, totaling thirteen applicable types of swaps requirements.[309] Entity-Level Requirements are swaps rules that "apply to a swap dealer . . . as a whole," and Transaction-Level Requirements are regulations that "apply on a transaction-by-transaction basis."[310]

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304 *Id.*

305 *Swap Dealer (SD) Registration*, NAT'L FUTURES ASS'N, https://www.nfa.futures.org/registration-membership/who-has-to-register/sd-msp.html (last visited Mar. 27, 2018).

306 *Id.* §§ 731(h)(3)(B), 764(g)(3)(B)(i)-(ii).

307 *Id.* §§ 731(e), 764(e)–(h).

308 *Id.* § 727(c). Business conduct standards were the subject of a January 11, 2012 final CFTC rule and applied to SDs and MSDs. Bus. Conduct Standards for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 9734 (Feb. 17, 2012). These standards enhance protections to swaps counterparties of SDs and MSPs through, *inter alia*, due diligence, disclosure, fair dealing and anti-fraud protections. *Id.* As is shown below, it appears that the CFTC never made clear that these business conduct standards were to apply extraterritorially where Dodd-Frank was to apply abroad until it issued a proposed rule on October 11, 2016. That rule was never finalized. *See infra* notes 442-48 and accompanying text.

309 COMMODITY FUTURES TRADING COMM'N, OFF. OF PUB. AFFAIRS, INTERPRETIVE GUIDANCE AND POL'Y STATEMENT REGARDING COMPLIANCE WITH CERTAIN SWAPS REGULATIONS (2013).

310 *Id.*

The CFTC identifies six main categories of Entity-Level Requirements: capital adequacy, chief compliance officer, risk management, swap data recordkeeping, swap data repository reporting, business conduct standards, and physical commodity large swaps trader reporting.[311] The seven Transaction-Level Requirements are categorized as: required clearing and swap processing, margining (and segregation) for uncleared swaps, mandatory trade execution, swap trade relationship documentation, real-time public reporting, trade confirmation, and daily trading records.[312]

It is important to note here, however, that U.S. bank holding company swap dealers –as opposed to their non-bank subsidiaries -- are "prudentially" regulated by the appropriate federal banking agencies,[313] and those banking institutions must comply with the swaps capital and margin requirements imposed by those *bank* regulators and not those established by the CFTC.[314]

However, while the rules set by prudential bank regulators exist as a separate body of margin and capital mandates from the CFTC's capital and margin rules, the differences between the two sets of regulations are considered minimal.[315]

Pertinent for the purposes of this paper, which focuses on whether the CFTC should apply its Dodd-Frank swaps rules to all swaps trades of foreign *non-bank* subsidiaries of U.S. bank

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311 *Id.*

312 *Id.*

313 *See* DEP'T OF TREAS., OFF. OF COMPTROLLER OF CURRENCY, MARGIN AND CAPITAL REQUIREMENTS FOR COVERED SWAP ENTITIES 5, n.4 (2016) ("The [Board of Governors of the Federal Reserve System] is the prudential regulator for any swap entity that is (i) a State-chartered bank that is a member of the Federal Reserve System, (ii) a State-chartered branch or agency of a foreign bank, . . . and (v) a bank holding company . . . .").

314 The U.S. prudential regulators are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration, and the Federal Housing Finance Agency. 80 Fed. Reg. 74840, 74839 (Nov. 30, 2015) ("For swap entities that are prudentially regulated by one of the Agencies, sections 731 and 764 of the Dodd-Frank Act require the Agencies to adopt rules jointly for swap entities under their respective jurisdictions imposing (i) capital requirements and (ii) initial and variation margin requirements on all swaps not cleared by a registered derivatives clearing organization or a registered clearing agency."); *see also* 12 C.F.R. pt. 45 (2016); 12 C.F.R. pt. 237 (2016); 12 C.F.R. pt. 349 (2016); 12 C.F.R. pt. 624 (2016); 12 C.F.R. pt. 1221 (2016).

315 Client Memorandum from Davis Polk & Wardwell LLP on U.S. Uncleared Swap Margin, Capital and Segregation Rules (Jan. 22, 2016), https://www.davispolk.com/publications/us-uncleared-swap-margin-capital-and-segregation-rules/; *Prudential Regulators and CFTC Adopt Margin Rules for Non-Cleared Swaps*, SIDLEY AUSTIN LLP (Jan. 20, 2016), https://www.davispolk.com/publications/us-uncleared-swap-margin-capital-and-segregation-rules/ (noting that substantive differences between the Prudential Regulators Final Rule and CFTC Final Rule are not particularly significant).

holding companies, those non-bank subsidiaries of SDs are fully subject to CFTC capital and margin rules (and not those of the banking regulators) to the extent that Dodd-Frank reaches those foreign subsidiaries through sensible extraterritorial rules.[316]

Dodd-Frank often imposes the clearing and exchange trading swaps requirements on standardized swap transactions.[317] Under clearing, a clearing facility stands between the buyer and seller of a contract to guarantee each against default by a counterparty.[318] To avoid their own liability, clearing facilities must therefore establish and strictly enforce the capital adequacy of swaps counterparties, and collect margins from swaps counterparties, *i.e.,* deposits on the amount at risk in a swaps trade.[319] Under Dodd-Frank, the regulatory agencies decide whether specific types of swaps must be cleared, and designated clearing organizations ("DCOs") must inform regulators about which types of swaps they plan to clear.[320] DCOs must allow "non-discriminatory" access by counterparties to clearing.[321] Swaps that are required to be cleared must also be traded on a designated contract market or a swaps execution facility ("SEF").[322]

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316 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 91253 (Dec. 6, 2016) (to be codified at 17 C.F.R. pt. 1, 23, 140) ("SDs and MSPs that are not banking entities, including nonbank subsidiaries of bank holding companies regulated by the Federal Reserve Board, are subject to the Commission's capital requirements."); *see also Prudential Regulators and CFTC Adopt Margin Rules for Non-Cleared Swaps*, SIDLEY AUSTIN LLP (Jan. 20, 2016), https://www.davispolk.com/publications/us-uncleared-swap-margin-capital-and-segregation-rules/ ("[A] nonbank subsidiary of a bank holding company — such as a nonbank swap dealer registered with the CFTC — would be . . . subject to the CFTC Final Rule rather than to the PR Final Rule.").

317 *See* Ownership Limitations and Governance Requirements for Sec.-Based Swap Clearing Agencies, Sec.-Based Swap Execution Facilities, and Nat'l Sec. Exchanges with Respect to Sec.-Based Swaps Under Reg. MC, 75 Fed. Reg. 65,882 (Oct. 26, 2010) (explaining some of the regulations the Dodd-Frank Act imposes on swap transactions).

318 *See generally* Jorge A. Cruz et al., *Clearing House, Margin Requirements, and Systemic Risk* (Aug. 31, 2010), https://www.researchgate.net/profile/Jeffrey_Harris7/publication/50422162_Clearing_House_Margin_Requirements_and_Systemic_Risk/links/02e7e527daa565f8bf000000.pdf?origin=publication_list.

319 *See generally id.*

320 Dodd-Frank Wall St. Reform & Consumer Prot. Act, Pub. L. No. 111-203, §§ 723(h)(2)(A), 763(a)(1) (2010).

321 *Id.* § 763(a)(2)(B).

322 *Id.* §§ 723(e), 763(a)(2)(B). Dodd-Frank contains a narrow "end-user" exception designed to ease the burden on businesses using swaps to mitigate risk associated with their commercial activities. The exception applies to parties that are not financial entities that are using swaps to hedge or mitigate commercial risk and have notified the CFTC and/or SEC (where appropriate) how they meet financial obligations of non-cleared swaps. An example of an eligible end user exemption would be airlines buying fuel using uncleared swaps to hedge against price increases. This end-user exemption does not include swaps in which both parties are major swap participants, swap dealers, or other large financial entities.

Dodd-Frank requires the reporting to federal regulators of *all* swaps, whether or not they are exempt from clearing and/or exchange trading.[323] All swaps must be reported to a registered swap data repository (SDR), the CFTC, or the SEC (where appropriate), and this reporting must occur as soon as technologically possible after swap execution.[324]

VI. Dodd-Frank was Clearly Intended to Apply to Swaps Executed Outside the U.S. if They Pose A "Direct and Significant" Impact on U.S. Commerce or if They Are Designed to Evade Dodd-Frank

A. Dodd-Frank's Extraterritorial Language

As explained below,[325] it was widely recognized at the time of Dodd-Frank's passage that swaps traded abroad by, *inter alia,* U.S. bank holding company swaps dealers, or their affiliates, contributed greatly to U.S. and worldwide economic destabilization in 2008, which in turn, required the massive multi-trillion-dollar U.S. taxpayer bank bailouts.

Just prior to Senate passage of Dodd-Frank on July 16, 2010, Senate Banking Committee Chairman, Chris Dodd, and Senator Jeff Merkley (a staunch supporter of Dodd-Frank and a member of the Senate Banking Committee) both commented about the risks associated with the U.S. financial institutions' domination of the *global* swap market[326] and how a U.S. bank's foreign subsidiaries could easily imperil that subsidiary itself, other affiliated subsidiaries, and the U.S. parent bank holding company as well.[327]

In those July 16, 2010 floor statements, it was made clear that Dodd-Frank would contain the tools to ensure that U.S. financial regulatory agencies would have the authority to identify swaps trading problems that emerge both domestically and around the world.[328] Indeed, it

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[323] *Id*. §§ 727, 731, 764 (2010).

[324] *Id.* §§ 727, 729, 763, 764.

[325] *See infra* notes 326-29 and accompanying text.

[326] 156 CONG. REC. S5828-53 (daily ed. July 14, 2010), http://www.gpo.gov/fdsys/pkg/CREC-2010-07-14/html/CREC-2010-07-14-pt1-PgS5828.htm (explaining that Dodd-Frank contains the tools to see to it that our regulatory agencies and others will have the capacity and the ability to identify and to spot early on problems that emerge both in the U.S. and around the world).

[327] 156 CONG. REC. S5870-902 (daily ed. July 15, 2010), http://www.gpo.gov/fdsys/pkg/CREC-2010-07-15/html/CREC-2010-07-15-pt1-PgS5870-2.htm.

[328] 156 Cong. Rec. S5828-53 (daily ed. July 14, 2010), http://www.gpo.gov/fdsys/pkg/CREC-2010-07-14/html/CREC-2010-07-14-pt1-PgS5828.htm.

was then widely recognized that a London-based foreign subsidiary of AIG – AIG Financial Products – sold huge numbers of CDSs and naked CDSs guaranteeing the viability of trillions of dollars of U.S. residential mortgages. The threatened AIG default on those swaps caused AIG to face economic ruin in the absence of an immediate $85 billion U.S. taxpayer bailout (and ultimately an approximately $180 billion bailout[329]). That bailout was to benefit, *inter alia*, many big U.S. bank holding company swaps dealers in their capacity as AIG counterparties on these CDS-based swaps.[330]

The clear concern by legislators was that reckless and poorly regulated swaps activity of foreign affiliates of U.S. financial institutions had already led (and could lead again) to cascading swaps defaults that quickly washed back to systemically risky U.S. bank holding company swaps dealers and would therefore require bailouts by U.S. taxpayers of those parent U.S. institutions.

Therefore Dodd-Frank expressly applied its swaps rules to swaps transactions executed outside of the U.S. in two important cases: (1) when those activities, "have a direct and significant connection with activities in, or effect on, commerce of the United States;" or (2) when activities, "contravene such rules or regulations as the Commission may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision [of Dodd-Frank]."[331]

With respect to the former, the CFTC has interpreted the language of the extraterritorial provision to mean that swaps rules apply, "to activities outside the United States that have either: (1) [a] direct and significant effect on U.S. commerce; or, in the alternative, (2) a direct and significant connection with activities in U.S. commerce, and through such connection present the type of risks to the U.S. financial system and markets that [the swaps provisions] directed the Commission to address."[332]

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329 Edmund L. Andres & Peter Baker, *A.I.G. Planning Huge Bonuses After $170 Billion Bailout*, N.Y. TIMES (Mar. 14, 2009), https://mobile.nytimes.com/2009/03/15/business/15AIG.html.

330 Shahien Nasiripour, *Goldman Sachs got Billions from AIG for Its Own Account, Crisis Panel Finds*, HUFF. POST (Jan. 26, 2011), http://www.huffingtonpost.com/2011/01/26/goldman-sachs-aig-backdoor-bailout_n_814589.html.

331 7 U.S.C. 2(i).

332 Interpretive Guidance and Pol'y Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45300 (July 26, 2013).

Just days before Dodd-Frank's Senate passage, the United States Supreme Court ruled in *Morrison v. National Australia Bank LTD.*[333] that a U.S. SEC financial regulatory statute would apply extraterritorially, only if that statute contained explicit language to that effect. The Court noted that, "it is a longstanding principle of American law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States,'[334] reaching the conclusion that, "[u]nless there is 'the affirmative intention of the Congress clearly expressed,' we must presume it 'is primarily concerned with domestic conditions.'"[335]

Congress, therefore, specifically and directly responded to *Morrison,* when three days later, on June 24, 2010, it added the extraterritorial language quoted above to Dodd-Frank in Section 722 (i).[336] The intent of Congress was clear: it wanted to ensure that, *inter alia*, the CFTC had the power to regulate extraterritorial activities with "direct and significant" effects on U.S. commerce and activities transacted outside the U.S. with the intent to "evad[e] Dodd-Frank."[337]

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333 561 U.S. 247 (2010).

334 *Id.* at 255 (quoting *EEOC v. Arabian Am. Oil Co.*, 499 U.S. 244, 248 (1991) (quoting *Foley Bros., Inc. v. Filardo*, 336 U.S. 281, 285 (1949))).

335 *Morrison* at 248 (citing *EEOC*, 499 U.S. at 248).

336 156 CONG. REC. H5205, H5237 (daily ed. June 30, 2010) (statement of Rep. Bachus) ("In the case of *Morrison v. National Australia Bank*, the Supreme Court last week held that section 10(b) of the Exchange Act applies only to transactions in securities listed on United States exchanges and transactions in other securities that occur in the United States. In this case, the Court also said that it was applying a presumption against extraterritoriality. This bill's provisions concerning extraterritoriality, however, are intended to rebut that presumption by clearly indicating that Congress intends extraterritorial application in cases brought by the SEC or the Justice Department."). It should be noted that these statements address claims brought by the SEC and DOJ, because they are responsive to the facts of *Morrison* (a case of an Australian bank, being sued for securities fraud, by Australians, for activities in Australia, on Australian exchanges), however the actual amendment language makes it clear that the amendment language extends jurisdiction to all swaps regulators. Congress's intent has been accepted as a reversal of *Morrison* in notable cases already. *See, e.g., S.E.C. v. Tourre*, No. 10 Civ. 3229(KBF), 2013 WL 2407172, at *1 n.4 (S.D.N.Y. June 4, 2013) ("Because the Dodd–Frank Act effectively reversed *Morrison*"); *In re Optimal U.S. Litig.*, 865 F. Supp. 2d 451, 456 n.28 (S.D.N.Y. 2012); S.*E.C. v. Compania Int'l Financiera S.A.*, No. 11 Civ. 4904(DLC), 2011 WL 3251813, at *6 n.2 (S.D.N.Y. July 29, 2011).

337 Richard Painter et al., *When Courts and Congress Don't Say What They Mean: Initial Reactions to Morrison v. National Australia Bank and to the Extraterritorial Jurisdiction Provisions of the Dodd-Frank Act*, 20 MINN. J. INT'L L. 1, 2–3 (2011).

B. The CFTC's July 2013 Extraterritorial Guidance: Swaps Executed by Guaranteed U.S. Bank Holding Company Foreign Subsidiaries Are Covered by Dodd-Frank's Swaps Regulation

In the roughly three years after the passage of Dodd-Frank, the CFTC mostly completed what has been recognized as the arduous, unprecedented, "Herculean feat"[338] of finalizing over sixty substantive rules, exemptive orders, and guidance actions.[339] When the CFTC met on July 12, 2013 to implement the statute's extraterritoriality provision, the then-CFTC Chairman, Gary Gensler, made it clear that it had been impossible to determine the extraterritorial reach of the swaps rules until the substance of those rules were in place. He said:

> "We're well over 90 percent through the various rule and guidance writing. And the markets are probably well towards half way implementing these reforms. . . so now . . . it is time for reforms to properly apply to and cover those activities that, as identified by Congress in section 722 . . . of the Dodd-Frank Act, have 'a direct and significant connection with activities in, or effect on, commerce of the United States.'"[340]

It was at that meeting that the CFTC issued its "final guidance" on the extraterritorial effect of its swap rules, determining when the Dodd-Frank swaps rules would be applied to swaps transactions executed outside the United States (the "July 2013 guidance").[341]

It is at this point that a common sense analysis of the extraterritorial application of Dodd-Frank must be addressed. The worldwide swaps market is valued at hundreds of trillions

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338 Annette L. Nazareth & Gabriel D. Rosenberg, *Eight US Regulatory Predictions for 2017*, FIN. TIMES (Jan. 13, 2017), https://www.ft.com/content/79955066-d81f-11e6-944b-e7eb37a6aa8e.

339 For a complete list of rules, exemptive orders and guidance actions see *Final Rules, Guidance, Exemptive Orders, and Other Actions*, U.S. CFTC, http://www.cftc.gov/LawRegulation/DoddFrankAct/Dodd-FrankFinalRules/index.htm (last visited Mar. 1, 2017). As of January 2017, seventy-four total rules have been created to implement Dodd-Frank. Fourteen of those rules were created and implemented after the July 2013 Guidance was released. During the period that the CFTC was busy establishing the framework of regulations pertaining to Dodd-Frank, many market participants, including U.S. and non-U.S. persons that would be subject to eventual registration and other swaps rules under the July 2013 Guidance were exempted from compliance under a tapestry of CFTC no-action letters and exemptive orders. A list of expired no-action letters can be found at *Expired Staff No-Action Letters*, U.S. CFTC, http://www.cftc.gov/LawRegulation/DoddFrankAct/ExpiredNoAction/index.htm (last visited Mar. 2, 2017). *See* Relevant Exemptive Order Regarding Compliance with Certain Swap Regulations, 78 Fed Reg. 43,785 (July 22, 2013). Despite the huge amount of work that went into implementing Dodd-Frank, those sixty regulations, orders, and guidance statements did not address their application extraterritorially. *Sec. Indus. and Fin. Mkts. Ass'n v. CFTC*, 67 F. Supp. 3d 373, 384 (D.D.C 2014).

340 Opening Statement of Chairman Gary Gensler at the Open Meeting to Consider Cross-Border Guidance and Exemptive Order (July 12, 2013), http://www.cftc.gov/PressRoom/SpeechesTestimony/genslerstatement071213; *see also* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013).

341 Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013).

of dollars in notional value. Among the biggest players in that market are four U.S. bank holding company swaps dealers which: (1) comprise 90% of the U.S. swaps market trading volume; (2) are headquartered and have their principal place of business in the U.S.; (3) have been deemed under Dodd-Frank by the U.S. Financial Stability Oversight Council to be systemically important (and thus likely to call upon U.S. taxpayer bailouts upon their threatened failure); and (4) were aided by the U.S. taxpayer in the 2008 meltdown to the tune of trillions of dollars.[342] Those banks are: Citibank, JPMorgan Chase, Goldman Sachs, and Bank of America.

Moreover, as one expert analyst of the world's financial stability explained only a little over two years ago,

> "[as recently as] April 2016, the US [financial] regulators issued a failing grade to five big [U.S.] banks (including Bank of America . . . and JPMorgan Chase [the two largest U.S. swaps dealers]) on their emergency wind down plans in a crisis-like situation.[343] Put simply, if another financial crisis [had] hit [the] US [in April 2016 or soon thereafter], these banks would [have] certainly need[ed] a bailout from the US government to prevent a major financial crisis from happening."[344]

When one looks at the substantial swaps trading of these four banks and then examines Dodd-Frank's clear mandate that extraterritorial U.S. bank activities that "have a direct and significant connection with activities in, or effect on, commerce of the United States," are subject

[342] The Financial Stability Oversight Council ("FSOC") lists these big four institutions at the top of the 2016 list of global systemically important banks ("G-SIBs"). The FSOC adopts the list of G-SIBs from the Financial Stability Board ("FSB"), and makes recommendations based on that maintained list. *See* Financial Stability Board, 2016 List of Global Systemically Important Banks (G-SIBs), Nov. 21, 2016, http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf.

[343] Although both Bank of America and JPMorgan Chase passed the Federal Reserve's annual stress test for the first time in 2017, the 2016 failures still demonstrate solvency volatility in this regard. *See* Liz Hoffman & Ryan Tracy, *Fed 'Stress Tests' Clear All Banks to Issue Payouts to Shareholders*, WALL ST. J. (June 28, 2017, 7:45 PM), https://www.wsj.com/articles/feds-stress-tests-all-banks-cleared-on-payouts-to-shareholders-1498681800.

[344] WEED, INT'L FIN. & G20 VOICES FROM THE GLOBAL SOUTH 12 (Feb. 2017), http://www2.weed-online.org/uploads/international_finance_g20_voices_from_the_global_south.pdf; *See* Financial Stability Board, 2017 List of Global Systemically Important Banks (G-SIBs), Nov. 21, 2017, http://www.fsb.org/wp-content/uploads/P211117- 1.pdf; *See* Office of the Comptroller of the Currency, Quarterly Report on Bank Trading and Derivatives Activities, 37 (Dec. 2017), https://www.occ.treas.gov/topics/capital-markets/financial-markets/derivatives/dq317.pdf; Ryan Tracy, *Big U.S. Banks Get Satisfactory Grades on 'Living Wills'*, WALL STREET J. (Dec. 19, 2017), https://www.wsj.com/articles/big-u-s-banks-get-satisfactory-grades-on-living-wills-1513719024; John Heltman, *Regulators Approve Big Banks' Living Wills —With a Warning*, AM. BANKER (Dec. 19, 2017), https://www.americanbanker.com/news/regulators-approve-big-banks-living-wills-with-a-warning ("In its latest evaluation, the regulators said the plans of the eight biggest institutions passed muster, but cited areas of improvement for Bank of America, Goldman Sachs, Morgan Stanley and Wells Fargo. All four must revise their resolution plans when they make their next submission in 2019. 'Reflecting the significant progress made in recent years, the [Federal Deposit Insurance Corp.] and the Federal Reserve Board on Tuesday announced that the resolution plans of the eight largest and most complex domestic banking organizations did not have 'deficiencies,' which are weaknesses severe enough to trigger a resubmission process that could result in more stringent requirements,' the agencies said in a joint release.").

to all Dodd-Frank swaps regulations wherever those trades are executed world-wide, it is self-evident that that statute applies to all of those four banks' swaps transactions wherever and by whomever executed. And, if that straightforward analysis were, in fact, the way in which Dodd-Frank was applied extraterritorially, the question of whether U.S. swaps law or foreign swaps law (or lack of foreign law) applied to all *other* swaps trades would be a matter of much smaller consequence. Defaults on *foreign* swaps trades by all other U.S. institutions would be relatively small, and they very likely could be handled effectively either by traditional bankruptcy law or by the "wind down" provisions required by Dodd-Frank itself.[345]

However, rather than apply that simple and straightforward approach of the Dodd-Frank extraterritorial plain language test quickly and directly to these four huge U.S. bank holding companies, the CFTC, beginning with its July 2013 guidance, embarked upon a Rube Goldberg-like[346] "one size fits all," overly complex extraterritorial set of rules without any specific reference to these four huge U.S. bank holding companies that dominate U.S. swaps trading. The needless complexity of the CFTC cross-border guidance has drawn harsh criticism from all sides of the regulatory spectrum (*e.g.*, from pro-regulatory market reformers to the swaps industry itself) as having: "created significant uncertainty;" "inconsistencies and ambiguities;" "analytic inconsistencies;" "a regulatory maze;" "textual twists and turns [leading to] dead ends;" "overly fine . . . distinctions;" and "mak[ing] practical applications [of the July 2013 guidance] difficult."[347] This uncertainty and confusion was further enabled by the CFTC's observation that its July 2013 extraterritorial guidance was "a statement of general policy intended to

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345 David Skeele, *Single Point of Entry and the Bankruptcy Alternative*, PENN LAW: LEGAL SCHOLARSHIP REPOSITORY (Feb. 26, 2014), http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1949&context=faculty_scholarship.

346 A comic exemplar "of [someone] doing something simple in a very complicated way that is not necessary." Merriam-Webster Dictionary, *Rube Goldberg* (last visited Apr. 6, 2017), http://www.learnersdictionary.com/definition/Rube%20Goldberg.

347 Johnson & Hazen *supra* note 70, at 288; William Shirley, *Guarantees, Conduits, and Confusion Under the CFTC's Cross-Border Guidance*, 34 J. L. INVESTMENT & RISK MANAGEMENT PRODUCTS 1 (2014) ("In adopting its cross-border guidance for Dodd-Frank swap regulation, the CFTC created a regulatory maze . . . . The CFTC's guidance on this subject not only created distinctions that arguably are overly-fine, but introduced textual twists and turns and analytic inconsistencies and dead ends that make practical application difficult."); *see also* Max Stendahl, *Murky Guidance Undermines CFTC's Derivatives Plans*, LAW360 (July 12, 2013, 6:28 PM), https://www.law360.com/articles/456853/murky-guidance-undermines-cftc-s-derivatives-plans ("Wall Street attorneys warned of a backlash and even potential litigation as clients struggle to untangle the guidance to determine which deals fall under which jurisdictions."); *see also* Micah Green et al., *Five Key Facts About the SEC's and CFTC's Cross-Border Regulatory Approaches*, BLOOMBERG (Jan. 24, 2014), https://www.law360.com/articles/456853/murky-guidance-undermines-cftc-s-derivatives-plans ("The CFTC Final Guidance also fails to fully reflect years of global regulatory coordination and risks becoming the outlier . . . ."

allow for flexibility in application to various situations and the consideration of all relevant facts and circumstances."[348]

As heroic was the CFTC's valiant three-year effort to meet tough statutory deadlines to implement, for example, over 50 final substantive Dodd-Frank swaps rules mandated by that statute,[349] its effort to deal with extraterritoriality has fostered virtual regulatory chaos. It is difficult (if not impossible) to state with complete certainty or clarity the manner in which the entirety of the CFTC's Dodd-Frank extraterritorial rules apply.

However, as discussed immediately below, there are two sets of circumstances that make crystal clear that the CFTC's extraterritorial rulings have opened gaping loopholes in Dodd-Frank swaps regulation by enabling, for example, the four big systemically-risky U.S. bank holding companies to shift, at their own discretion, U.S. swaps trading within their corporate family abroad and, as the regulatory law now stands, out from under Dodd-Frank.

VII. Swaps Are Moved by U.S. Swaps Dealers from the U.S. to their Own "De-guaranteed" Subsidiaries Abroad

The first circumstance showing that the July 2013 guidance created a massive loophole from Dodd-Frank swaps regulation is that there is every indication that swaps trading has had a significant movement from the U.S. to abroad. For example, in a widely cited study, Reuters found that "by December of 2014, certain U.S. important swaps markets had seen 95 percent of their trading volume disappear in less than two years."[350] The term "disappear" is not quite accurate, because it is not that U.S. bank holding company swaps dealers, for example, no longer

348 Johnson & Hazen *supra* note 70, at 288.

349 DAVIS POLK, DODD-FRANK PROGRESS REPORT 4 (2016) (As of July 19, 2016, the CFTC has issued a total of 51 rules to implement Title VII regulation of Dodd-Frank).

350 *Id.* (describing the time period between creation of the deguarantee loophole, and the writing of the article); Banks and end-users told GAO that moving the swaps can increase their risks and, in turn, costs. Such risks and costs likely would have been greater under the original version because of its broader scope,' GAO said."); Andrew Ackerman, *Fed Considers Easing Capital Rule Seen as Hampering Swaps Market Critics Including Treasury and CFTC Urge Relaxing Regulation, Saying it has Undermined Key Part of Dodd-Frank*, Wall St. J. (June 14, 2017), https://www.wsj.com/articles/fed-considers-easing-capital-rule-seen-as-hampering-swaps-market-1497432602; Morrison Foerster, *The Treasury Report's Recommendations for Derivatives Regulation*, 4 (Oct. 26, 2017), https://media2.mofo.com/documents/171026-treasury-report-derivatives.pdf ("With respect to so-called 'ANE' transactions, trades between non-U.S. entities but 'arranged, negotiated or executed' by personnel located in the United States, Treasury recommends that the CFTC and SEC reconsider any U.S. personnel test as a basis to apply transaction-based requirements and, in particular: … the CFTC and the SEC should reconsider the implications of applying their Title VII rules to transactions between non-U.S. firms or between a non-U.S. firm and a foreign branch or affiliate of a U.S. firm merely on the basis that U.S.-located personnel arrange, negotiate or execute the swap,

engage in these trades; rather, those institutions have moved many of their trades[351] "off shore" to their newly deguaranteed "foreign" affiliates which are otherwise wholly consolidated on the U.S. bank holding companies' balance sheets, but deemed by those parent U.S. banks to be outside of Dodd-Frank for the sale of swaps to non-U.S. persons.[352]

especially for entities in comparably regulated jurisdictions."); Iñaki Aldasoro and Torsten Ehlers, *Risk Transfers in International Banking*, BANK FOR INT'L SETTLEMENTS (Dec. 3, 2017), https://www.bis.org/publ/qtrpdf/r_qt1712b.htm; FIA and sifma, *Promoting U.S. Access to Non-U.S. Swaps Markets: A Roadmap to Reverse Fragmentation*, 3-7 (Dec. 14, 2017), https://www.sifma.org/wp-content/uploads/2017/12/Non-US-Trading-Platform-and-CCP-White-Paper-12-14-2017.pdf ("The increase in multilateral trading and central clearing of swaps markets since Congress enacted the Dodd-Frank Act increases the need for U.S. firms to have effective access to non-U.S. swaps trading venues and central counterparties ('CCPs')…. U.S. firms were forced off swaps trading venues in numerous jurisdictions stretching across the European Union ('EU') and Asia. U.S. banks were forced to subsidize their operations in order to access certain local CCPs…The implementation of the Dodd-Frank Act's SEF registration requirement in October 2013 and its mandatory trading requirement in February 2014 drove fragmentation of the global swaps markets by forcing non-U.S. swaps trading venues to deny participation by U.S. firms"); Andrew Ackerman, *CFTC Aims to Close Swaps Loophole for Large U.S. Banks*, WALL ST. J. (June 9, 2015), https://www.wsj.com/articles/cftc-aims-to-close-swaps-loophole-for-large-u-s-banks-1433856763; Dennis M. Kelleher, *Must-Read Investigative Report Highlights Wall Street's Latest Lobbying to Avoid Key Financial Reforms*, HUFFINGTON POST (Aug. 28, 2015); Douwe Miedema, *U.S. Regulator Plans to Close Swaps Trading Loophole*, REUTERS (June 9, 2015); Douwe Miedema, *U.S. Regulator Plans to Close Swaps Trading Loophole*, REUTERS (June 9, 2015); Kimberly Amadeo, *Credit Default Swap: Pros, Cons, Crises, Examples*, THE BALANCE (Aug. 17, 2017); Christopher Kirkpatrick, *Comment on the Proposed Margin Requirements for Uncleared Swaps for Swaps Dealers and Major Swaps Participants*, INST. FOR AGRICULTURE TRADE AND POL'Y (Sept. 14, 2015); Silla Brush, *CFTC Proposes Narrowing Wall Street's Foreign Swaps Loophole*, Bloomberg (June 29, 2015).

351 Trades are executed through de-guaranteed affiliates of the large parent U.S. bank swap dealer.

352 *See id.*; Charles Levinson, *U.S. Banks Moved Billions of Dollars in Trades Beyond Washington's Reach*, REUTERS (Aug. 21, 2015), http://www.reuters.com/investigates/special-report/usa-swaps/. Levinson provides the example that:

> "The global inter-dealer market for interest rate swaps in Euros is one of the largest derivatives markets in the world. U.S. banks' monthly share of the market had plunged nearly 90 percent since January 2013, from over $1 trillion to $125 billion, according to ISDA. The data were misleading. U.S. banks were still trading as vigorously as ever. But their trades, booked through London affiliates, without any credit guarantees linking them back to the U.S., were now showing up in the data as the work of European banks."

While some have questioned Levinson's figures, as his study indicates, there are many expert swaps market observers and participants, who by their own calculations have seen a major swaps movement out of the U.S. to foreign deguaranteed subsidiaries. *Id.* Whatever the exact percent of that foreign movement (which is obscured by a lack of transparency) there is a widespread consensus that it is substantial, i.e., large enough that cascading defaults of those swaps trades could cause a systemic break in the world economy. Precise analysis also becomes more complicated by the fact, as footnote 563 of the CFTC guidance makes clear, the deguaranteed subsidiary registered with the CFTC as a swaps dealer can only evade Dodd-Frank under the loophole if its counterparty is not a "U.S. person." *CFTC Issues Cross-Border Substituted Compliance Determinations, Provides Limited Phase in for Some Swap Requirements*, Davis Polk (Jan. 7, 2014), https://www.davispolk.com/files/01.07.14.CFTC_.Issues.CrossBorder.Substituted.pdf. If the counterparty is a "U.S. person", those trades are covered by Dodd-Frank. Again, informed market observers suspect that just as U.S. banks shed their "U.S. person" status when deguaranteeing their foreign subsidiaries, a similar approach could be adopted by what would otherwise be a "U.S. person" bank counterparty, becoming itself a deguaranteed foreign subsidiary (and thus becoming a "non-U.S. person"). There is a doubtless near universal sense that the deguarantee loophole is taking a substantial portion of swaps out from under Dodd-Frank. Indeed, it is also likely, as Levinson suggests, that some of these market observers tipped off the CFTC staff about the ISDA loophole, because the CFTC was otherwise never informed by swaps traders or anyone else of the "creation" of that loophole in August 2013. *Id.* Levinson reports that the CFTC did not learn of the loophole until many months into 2014. *Id.*

Also, an examination of interest rate swaps trading alone shows that beginning in 2014 the volume of trades between European and U.S. swaps dealers declined 77%.[353] CFTC Chairman (then Commissioner) Giancarlo attributes this decline directly to: "[n]on-U.S. persons avoiding financial firms bearing the scarlet letters of 'U.S. person' in certain swaps products to steer clear of the CFTC's problematic regulations."[354] Chairman Giancarlo is right in thinking that business is being channeled to "non-U.S." persons to avoid the Dodd-Frank swaps regulations. Where his characterization falters is that *truly* foreign bank competitors are not winning the bulk of this swaps business; instead that business is largely being shifted within the U.S. bank holding company swaps dealers to their own newly "deguaranteed" foreign affiliates that are nevertheless fully consolidated on the parent U.S. banks' balance sheets, but deemed by the CFTC to be "non-U.S. persons."

Even before the CFTC issued its final guidance on extraterritorially in July 2013, Goldman Sachs successfully anticipated the future on the foreign subsidiary extraterritorial loophole in 2012 by demanding that its clients wishing to use Goldman Sachs as its preferred swaps counterparty give the bank standing permission to move swaps trades to different Goldman Sachs foreign subsidiaries around the world, whenever and wherever Goldman Sachs saw fit.[355] In this regard:

> "[I]t meant that a client might strike a derivatives deal with Goldman in New York in the morning, and that afternoon, with no disclosure, a Goldman office in London or Singapore or Hong Kong could take over the deal. With each shift, the trade could fall under different [foreign] regulators - but not under the CFTC's purview and the Dodd-Frank rules."[356]

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353 Audrey Costabile Blater, *Revisiting Cross-Border Fragmentation of Global OTC Derivatives: Midyear 2014 Update*, ISDA RESEARCH NOTE, at 1–5 (Jul. 24, 2014), http://www2.isda.org/functional-areas/research/research-notes.

354 J. Christopher Giancarlo, Commissioner, Keynote Address of CFTC Commissioner J. Christopher Giancarlo before the ISDA's Trade Execution Legal Forum (Dec. 9, 2016), http://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlo-18.

355 Levinson, *supra* note 351.

356 *Id.*

The purpose of this tactic was clearly designed to evade, at the U.S. banks' will, the U.S. Dodd-Frank swaps jurisdiction.[357]

As will be described in detail below, two further tactics were unilaterally adopted by, *inter alia*, the big U.S. bank holding swaps dealers and their representatives beginning in August 2013 to "escape" Dodd-Frank swaps rule application to their purported "foreign" trades. Suffice it to say for present purposes, these swaps dealers, *inter alia*:

- "Deguaranteed" their previously "guaranteed" foreign subsidiaries through a box-checking exercise in the standardized industry swaps contract documentation, thereby claiming the ability to evade the CFTC's July 2013 guidance that only foreign "guaranteed" subsidiaries would fully be subject to Dodd-Frank.[358]
- Followed a practice of having swaps arranged, negotiated and executed ("ANE") *in the United States* by *U.S. personal* and then "assigning" the already executed swap to a recently deguaranteed foreign affiliate, claiming that Dodd-Frank does not apply.[359]

VIII. The CFTC Too Belatedly Tries to End the Deguarantee and ANE Loopholes

The second factor that clarifies any possible confusion over the U.S. swaps dealers' readings of the July 2013 guidance as described immediately above is that the CFTC, in an October 18, 2016 proposed rule and accompanying interpretations, expressly recognized and then proposed to close fully both the "deguarantee" and "ANE" loopholes.[360] In that October 2016 proposal, the CFTC made clear that if U.S. personnel in the U.S. arranged, negotiated and executed a swap, Dodd-Frank would apply even if the swaps were later "assigned" to a recently deguaranteed foreign subsidiary.[361] Additionally, *any* foreign affiliates included within a U.S. bank

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[357] *See id.* ("An industry executive familiar with Goldman's thinking said the agreement was meant to help clients by giving them flexibility to move trades outside U.S. jurisdiction if they wished. 'It was an option for those who wanted that flexibility,' this person said.").

[358] *See infra* notes 402-15 and accompanying text. It may be that the deguaranteed bank subsidiary can only trade swaps outside of Dodd-Frank swaps regulation if its counterparty is a "non-U.S. person." See *supra* note 351. However, the ease with which the U.S. swaps dealers have converted themselves from "U.S. persons" to "non-U.S. persons" makes clear that it would be similarly easy to convert by corporate engineering a "U.S. person" foreign subsidiaries' counterparty into a "non-U.S. person", thereby clearly exempting the transaction from Dodd-Frank swaps regulation in that event as well.

[359] *See infra* notes 450-51 and accompanying text.

[360] *See infra* notes 437-57 and accompanying text.

[361] *Id.*

holding company swaps dealer's consolidated balance sheet would be required to comply with Dodd-Frank, thereby eliminating the significance of the recent deguarantees.

However, the CFTC's October 2016 proposed rule and interpretations were not finalized under the time-consuming procedural federal rule-making process before the inauguration of President Donald Trump, and there is virtually a unanimous consensus that a Trump-controlled CFTC (or a Republican Congress) will never finalize those rulings.[362] Accordingly, U.S. bank holding company swaps dealers' "foreign" assignment of swaps to newly deguaranteed subsidiaries, even if the swaps are arranged, negotiated and executed in the U.S. by U.S. personnel, can at the U.S. bank swaps dealer's discretion evade Dodd-Frank. (Even if the Republicans lost control of one or both Houses in the 2018 mid-term, legislation eliminating these loopholes would almost certainly be vetoed by President Trump). As a result, certain failing and systemically risky swaps trades threatening another meltdown will almost surely lead to a call for U.S. taxpayers to once again bail out these big U.S. banks to avoid the calamity of a Second Great Depression.[363]

At this juncture, it may be fair to ask that if President Trump, his CFTC, and the Republican-controlled Congress are "speak[ing] of dismantling the Dodd-Frank Act",[364] why should one worry about the administrative loopholes to that statute's application to "foreign" swaps if the statute itself will disappear?[365]

Indeed, all supporters of the diverse regulatory approaches to swaps regulation (from supporters of the Dodd-Frank swaps regime to the large U.S. bank holding company swaps dealers) are forecasting that there will be little statutory change to that part of Dodd-Frank that specifically addresses regulation of the swaps market; for example, "[b]anking executives . . .

362 *See infra* notes 452-57 and accompanying text.

363 Glenn Thrush, *Trump Vows to Dismantle Dodd-Frank 'Disaster',* N.Y. TIMES (Jan. 30, 2017), https://www.nytimes.com/2017/01/30/us/politics/trump-dodd-frank-regulations.html?_r=0.

364 Annette L. Nazareth & Gabriel D. Rosenberg, *Eight US Regulatory Predictions for 2017*, FIN. TIMES (Jan. 13, 2017), https://www-ft-com.ezproxy.law.umaryland.edu/content/79955066-d81f-11e6-944b-e7eb37a6aa8e.

365 *Id.*

now are moving [] quickly [to] head off President . . . Trump and other [Dodd-Frank] critics who are talking about dismantling [the] statute entirely according to the Wall Street Journal. . . .'We're not for wholesale throwing out Dodd-Frank, said JP Morgan Chase . . . CEO Jamie Dimon.'"[366]

Big bank reticence about the need for statutory change to Dodd-Frank's swaps regulatory regime is almost certainly the result of three factors. First, legislation proposed by the Nation's biggest banks seeking relief from Dodd Frank's critically important swaps regulation would surely be viewed as highly unpopular. While the mainstream economy has still not yet-fully recovered from the Great Recession,[367] Americans well know that these big banks have all been bailed out to the tune of trillions of dollars by the U.S. taxpayer, and those banks have remained financially strong (if not stronger) since the Great Recession ended, if not before that.[368] These banks are now considered by key U.S. financial regulators to be "systemically important," *i.e.,* if they collapse in future economic disasters, there will likely be a corresponding call upon U.S. taxpayers for further trillion dollar bailouts. The passage of a bill to undo Dodd-Frank's swaps regulation for these big banks, even in the Republican controlled House and Senate, would almost certainly be politically unfeasible.

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366 Mark Kolakowski, *Dodd-Frank How Bank CEOs Want It Changed* (INVESTOPEDIA December 12, 2016), https://www.washingtonpost.com/news/powerpost/paloma/the-finance-202/2018/04/27/the-finance-202-hensarling-compromise-clears-a-path-for-bank-deregulation/5ae24cad30fb0437119268d2/?utm_term=.99c7b08e6e81; *see also* Ben White & Victoria Guida, *Trump Expected to Pick Treasury Veteran as Top Bank Cop*, POLITICO (Apr. 14, 2017), http://www.politico.com/story/2017/04/banking-regulations-trump-treasury-237271 ("The selection [of former Treasury undersecretary, Randy Quarles, as the Federal Reserve's top regulator sends] a clear signal that the [Trump] administration is looking to take a pragmatic approach to paring back bank regulation, rather than choosing an ideologue who would seek to eviscerate the rules enacted since the financial crisis."); Gabriel T. Rubin, *Swaps Rules Due for Overhaul in Bid to Boost Liquidity*, Wall St. J. (Online) (April 26, 2018, 12:01 a.m. ET), https://www.wsj.com/articles/swaps-rules-due-for-overhaul-in-bid-to-boost-liquidity-1524715260 (CFTC Chairman Giancarlo "promised near term action *only on swap-execution rules*," *i.e.*, how a swaps trade is made, as opposed to revising the full panoply of rules reporting, transparency, collateral and capital rules governing the regulation of swaps.) (Emphasis added.)

367 *See* Poduk et al., *supra* note 91. ("[M]any people across the political spectrum complain that the recovery is uneven and the . . . grains are not fairly distributed.").

368 *See* Ben McLannahan, *Wall Street Bonuses Rise 17% to Pre-Crisis Levels*, FIN. TIMES (Mar. 26, 2018), https://www.ft.com/content/3b18dc52-3112-11e8-b5bf-23cb17fd1498 (noting that the amount of Wall Street bonuses have risen 17%, nearly reaching the "the peak levels of $33bn-$34bn recorded in 2006 and 2007 . . . ."); *see also* Ben McLannahan, *Dimon Pay Day Means a Year's Wages for Typical JPMorgan Staff*, FIN. TIMES (Mar. 22, 2018), https://www.ft.com/content/aac3a27a-2de4-11e8-9b4b-bc4b9f08f381 ("JPMorgan Chase chief executive Jamie Dimon earned as much in a day as the typical employee at his bank took home in the whole of last year . . . ."); *see also* Poduk et al., *supra* note 91 (explaining that "[a]verage bonuses and salaries on Wall Street have climbed back from the post crisis lows…[b]ut 10 years [after the financial crisis] the trend of large [financial] firms is still intact," while "[t]he financial sector is again becoming a bigger piece of the economy. That could translate to future risks for borrowers and consumers in another crisis.").

This lack of feasibility can be seen in the recent Congressional effort to provide "modest"[369] relief from Dodd-Frank's capital requirements imposed by prudential banking regulators to community and mid-size banks, the former with assets no greater than $10 billion and the latter with assets no greater than $250 billion.[370]

On March 14, 2018, the Senate, by a vote of 67-31, passed the Economic Growth, Regulatory Relief and Consumer Protection Act (S. 2155).[371] The bill was originally intended to provide capital requirement relief *only* for community banks, *i.e.*, those banks with less than $10 billion in assets.[372] Yet, in the process of crafting this legislation, provisions were added that *could* benefit banks that are larger than community banks. Section 401 of S. 2155 raises the threshold for possibly avoiding certain enhanced prudential regulations, *i.e*., liquidity standards, capital requirements, risk management standards, and other forms of supervision, to banks with up to $250 billion in assets, which was raised for those banks from Dodd-Frank's $50 billion threshold.[373] However, under Section 401, prudential banking regulators are not *required* to afford relief to mid-size banks (as they are required to do for community banks). They are only given the *discretion* to do so.[374] If prudential banking regulators exercise the discretion afforded (and that is a big "if" given many of those prudential regulators' concerns about *any*

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369 Andrew Ackerman, *Senate to House: Don't Risk Upending Deal on Dodd-Frank Rollback*, WALL STREET J. (Mar. 20, 2018, 5:16 PM), https://www.wsj.com/articles/senate-to-house-dont-risk-upending-deal-on-dodd-frank-rollback-1521568094.

370 *See* Burgess Everett et al, *Schumer Struggles to Contain Warren-Led Rebellion*, POLITICO (Mar. 14, 2018), https://www.politico.com/story/2018/03/14/schumer-warren-democrats-dodd-frank-460563; Bob Bryan & Joe Perticone, *The Biggest Wall Street Bill in Years is Tearing Democrats Apart*, BUS. INSIDER (Mar. 14, 2018), http://www.businessinsider.com/democrats-divide-elizabeth-warren-on-wall-street-bank-deregulation-2018-3.

371 Alan Rappeport, *Senate Passes Bill Loosening Banking Rules, but Hurdles Remain in the House*, N.Y. TIMES (Mar. 14, 2018), https://www.nytimes.com/2018/03/14/business/senate-banking-rules.html.

372 Tracy Ryan, *The Fine Print: What's in the Financial-Regulation Bill*, WALL STREET J. (Mar. 14, 2018), https://www.wsj.com/articles/the-fine-print-whats-in-the-senate-financial-regulation-bill-1520354942.

373 S. 2155, 115th Cong. §401 (2018).

374 S. 2155, 115th Cong. §401 (2018) (striking the word "shall" from how regulators are to impose requirements on large banks and replacing it with "may"); Jeff Stein, *Senate Banking Bill Likely to Boost Chance of Bank Bailout, CBO Says*, WASH. POST (Mar. 5, 2018), https://www.washingtonpost.com/news/wonk/wp/2018/03/05/senate-banking-bill-would-boost-the-chances-of-more-bank-bailouts-cbo-report-says/?utm_term=.1a2d1843f498 (noting that the change in Section 401 grants regulators far more discretion in how to impose regulations on large banks).

bank failures[375]), relief would likely be provided only to BB&T Corp. ($221 billion in assets), SunTrust Banks Inc. ($205 billion in assets), Charles Schwab Corp. ($243 billion in assets), and American Express ($181 billion in assets),[376] but expressly *not* to the 13 largest U.S. financial institutions, many of which have assets in amounts that are multiples of these mid-size bank assets.[377]

While affording even discretionary relief to these mid-size banks was itself very controversial,[378] the purposeful limitation of this deregulatory effort only to mid-size banks, and the fact that Section 401 expressly did not provide relief to the Nation's very largest banks, was constantly emphasized by even the very *deregulatory-oriented Republican drafters and chief proponents of S. 2155.*[379] Therefore, even the staunchest advocates for Dodd-Frank regulatory relief in this regard did not extend S. 2155 relief to the 13 largest U.S. financial institutions; and therefore not to the biggest swaps dealer banks: Citibank **(**with $1.843 trillion in assets), JPMorgan ($2.534 trillion in assets), Bank of America ($2.281 trillion in assets), and Goldman Sachs ($916 billion in assets).[380]

Additionally, Section 402 of S. 2155 reduces the supplementary leverage ratio established by the prudential banking regulators, *i.e.*, the amount of capital that a bank must keep on hand as a buffer for financial collapse, for "custodial banks."[381] Custodial banks are defined in the bill as "any depository institution holding company *predominantly* engaged in custody, safekeeping, and asset servicing companies, including any insured depository institution subsidiary

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375 See, *e.g.*, Jesse Hamilton, "*Wall Street Faces Higher Capital Demands under Fed Proposal*," (Bloomberg, April 10, 2018), https://www.bloomberg.com/news/articles/2018-04-10/fed-seeks-significant-over, haul-of-post-crisis-bank-capital-rules ("Wall Street banks could face higher capital hurdles under a Federal Reserve proposal that would mark the most significant rewrite of requirements put in place after the 2002 financial crisis"); see also Rachel Witkowski, *A Parting Warning from FDIC's Hoenig on Big-Bank Rules*, AM. BANKER (Mar. 28, 2018), https://www.americanbanker.com/news/a-parting-warning-from-fdics-hoenig-on-big-bank-rules ("In his last policy speech as the FDIC's vice chairman, Thomas Hoenig said it would be 'a serious policy mistake' to ease capital standards such as the 'supplementary leverage ratio' for megabanks.").

376 *Largest Banks in the United States*, https://www.relbanks.com/top-us-banks/assets (last visited Mar. 23, 2018).

377 Jim Puzzanghera, *Despite Stumbling Before the Financial Crisis, Federal Reserve Would Get New Discretion in Senate Banking Bill*, L.A. TIMES (Mar. 13, 2018), http://www.latimes.com/business/la-fi-fed-banking-deregulation-20180313-story.html.

378 Jeff Stein, *Senate Banking Bill Likely to Boost Chances of Bank Bailout, CBO Says*, WASH. POST (Mar. 5, 2018), https://www.washingtonpost.com/news/wonk/wp/2018/03/05/senate-banking-bill-would-boost-the-chances-of-more-bank-bailouts-cbo-report-says/?utm_term=.a0f224803654; *see also* Ackerman, *supra* note 369 ("Centrist Democrats have already weathered attacks from their more liberal colleagues for supporting [S.2155] and are loath to vote on it a second time.").

379 *Id.*

380 *Largest Banks in the United States*, https://www.relbanks.com/top-us-banks/assets (last visited Mar. 23, 2018).

381 S. 2155, 115th Cong. §402 (2018).

of such a holding company."[382] Currently, only three mid-size banks would be eligible for relief under Section 402 — Bank of New York Mellon, State Street, and the Northern Trust Corporation.[383]

However, two of the four largest U.S. bank holding company swaps dealers that are the subject of this paper were at first reported as desiring this type of regulatory relief: Citigroup and JPMorgan Chase. However, clearly to quell increasing public anger that the very biggest systemically important banks might receive deregulatory relief under S. 2155, both Federal Reserve regulatory chief Randal Quarles and JPMorgan Chase CEO, Jamie Dimon, said separately at different public fora after S. 2155's passage in the Senate that JPM "will not benefit" from the bill because that bill "only really affects[s] smaller banks, so it doesn't really have anything to do with us [.]"[384] Indeed, even according to S. 2155's Senate Republican deregulatory supporters, megabanks *are not and will not be* afforded relief under the terms of S. 2155. [385]

That S. 2155, which was initially only intended to bring relief to community banks (those under $10 billion in assets), might now benefit some of America's mid-size banks (up to $250 billion in assets), and has, in and of itself, been very controversial. That Section 402 might ultimately benefit Citigroup ($1.834 trillion in assets) and JP Morgan Chase ($2.534 trillion in assets) was emphatically opposed by S. 2155's principal drafters, who have continuously stressed that the act does not afford and was not intended to afford, deregulatory relief to any of the Nation's thirteen largest banks, including Citibank and JP Morgan Chase, the latter of which, through its CEO, has now denied any claim that the act's deregulatory impact would apply to it.[386]

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382 *Id.* (Emphasis added).

383 Aaron Back, *The Surprisingly Large Winners in a Bill to Help Small Banks*, WALL STREET J. (Mar. 14, 2018), https://www.wsj.com/articles/the-surprisingly-large-winners-in-a-bill-to-help-small-banks-1521019801.

384 David Dayen, *JPMorgan CEO: Banking Bill "Doesn't Really Have Anything to do With Us"*, THE INTERCEPT (Mar. 28, 2018), https://theintercept.com/2018/03/28/jpmorgan-crapo-banking-bill/; Victoria Guida, *Quarles: Citi, JPM Wouldn't Benefit from Proposed Change to Backup Capital Rule*, POLITICO Pro: Financial Services Whiteboard (April 19, 2018, 11:25 AM EDT), https://subscriber.politicopro.com/financial-services/whiteboard/2018/04/quarles-citi-jpm-wouldnt-benefit-from-proposed-change-to-backup-capital-rule-1069359.

385 As shown in footnote 383, *supra*, a CBO estimate that Citigroup and JPMorgan Chase currently have a 50 percent chase of being included under Section 402 of S. 2155, has been rebutted by JPM's CEO, the Federal Reserve regulatory chief, and the Republican Senate sponsors of the bill. For the CBO estimate, see CONG. BUDGET OFFICE, COST ESTIMATE: S. 2155 ECONOMIC GROWTH, REGULATORY RELIEF, AND CONSUMER PROTECTION ACT (2018).

386 Erica Werner & Renae Merle, *Senate Passes Rollback of Banking Rules Enacted After Financial Crisis*, WASH. POST (Mar. 14, 2018), https://www.washingtonpost.com/business/economy/senate-passes-rollback-of-post-financial-crisis-banking; *see also* Ackerman, *supra* note 369 ("The relatively modest Senate bill, [Republican Senator Tillis] added, reflects the political reality of what can be accomplished in the Senate, where Republicans hold 51 seats and generally need support from nine Democrats to pass legislation.").

While S. 2155 enjoyed enough bipartisan support in the Senate to overcome a filibuster there, that bill, after Senate passage, required the passage of complementary legislation in the House to become a law. But, in the House, leading Republicans were at first not happy with S. 2155 as passed by the Senate. For example, Jeb Hensarling, Chairman of the House Financial Services Committee originally did not support S. 2155 as passed by the Senate, because it did not afford *enough* deregulation.[387] He therefore sought negotiations with those 17 Senate Democrats (including one independent who votes with Democrats) who voted for S. 2155 to see if an agreement could be reached on Hensarling's further regulatory relief proposals.[388] However, those Senate Democrats, already facing a severe backlash for supporting a bill that many have criticized as already providing too much regulatory relief, were unwilling to negotiate further.[389] Indeed, after Senate passage of S. 2155, the big U.S. bank holding companies themselves faced increasing criticism from their own shareholders for trying to weaken Dodd-Frank.[390] And, leading Senate Republicans therefore advised House Republicans, including Hensarling, that "there is little political appetite in the Senate to vote on a revised version of [S.2155]," and, as a result, Hensarling "accept[ed] [the] deregulatory package that passed the Senate . . . without changes," thereby allowing the Senate bill to pass the House and thus be enacted into law on May 24, 2018.[391]

In short, any proposed legislation for the principal benefit of four huge systemically problematic U.S. bank holding company swap dealers that would go much further than S. 2155 to not only afford capital reserves relief, but also diminish the *entirety* of the thirteen types of

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387 Zachary Warmbrodt, *Hensarling's Last Stand; Blocking Banking Bill*, POLITICO (Mar. 15, 2018), https://www.politico.com/story/2018/03/15/jeb-hensarling-bank-deregulation-bill-418536.

388 *Id.*

389 Victoria Finkle & Rob Blackwell, *Is This Jeb Hensarling's Last Stand?* AM. BANKER (Mar. 19, 2018), https://www.americanbanker.com/news/is-this-jeb-hensarlings-last-stand (noting that Democrats "insist there's no more room for negotiation" on the bill).

390 *See* Ben McLannahan, *Citigroup and Goldman Face Shareholder Pressure on Lobbying*, FIN. TIMES (Apr. 3, 2018), https://www.ft.com/content/33285f2e-3471-11e8-ae84-494103e73f7f.

391 As the Washington Post editorial board observed: "The big story about [S. 2155] is not how much damage the Wall Street lobby has managed to do to Dodd-Frank, but, how little." Editorial Board, *The story isn't how much Dodd-Frank has been changed. It's how little*, The Washington Post (May 26, 2018), https://www.washingtonpost.com/opinions/the-story-isnt-how-much-dodd-frank-has-been-changed-its-how-little/2018/05/26/19018406-5eb8-11e8-a4a4c070ef53f315_story.html?utm_term=.97a16679d014. *See*, *e..g.*, https://www.cbsnews.com/news/trump-signs-bill-dodd-frank-banking-regulation-roll-back-dodd-frank-act-today-live-stream-up-dates/(signing ceremony of S. 2155). *See also* Tory Newmayer, "*The Finance 202: Hensarling compromise clear a path for bank deregulation,"* (WASHINGTON POST, April 27, 2018), https://www.washingtonpost.com/news/powerpost/paloma/the-finance-202/2018/04/27/the-finance-202-hensarling-compromise-clears-a-path-for-bank-deregulation/5ae24cad30fb0437119268d2/?utm_term=.99c7b08e6e81; Ackerman, *supra* note 369; Sylvan Lane, *Frustration Mounts as Dodd-Frank Rollback Stalls*, THE HILL (Mar. 25, 2018), http://thehill.com/policy/finance/380027-frustration-mounts-as-dodd-frank-rollback-stalls ("The financial industry is trying to break the jam. They now fear the bill could die with little time for Congress to act before attention shifts to the midterm elections.").

swaps regulation now required by Dodd-Frank is far from likely to pass even in a Republican controlled Congress. These huge banks know this, and this political reality almost certainly explains big bank reticence in affirmatively seeking to undermine directly Dodd-Frank's swaps regulation.[392]

Second, powerful influences within the Trump Administration and both prominent Congressional Republicans and Democrats have touted the reinstatement of a so-called "modern day" Glass-Steagall as a major policy initiative, including President Trump himself; former National Economic Council Director (and former Goldman Sachs COO), Gary Cohn; Secretary of the Treasury, Steve Mnuchin; outgoing Federal Deposit Insurance Corporation, Vice Chairman, Thomas Hoenig; and Steve Bannon, President Trump's former chief strategist.[393] Glass-Steagall,

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[392] The recent proposal by the U.S. Federal Reserve to change administratively the Volcker Rule *regulations* – as opposed to seeking a *statutory* change to that Rule -- is not to the contrary. See ***e.g.*** Benjamin Bain & Robert Schmidt, *Wall Street Gets Win as Fed Set to Ease Volcker Trade* Limits, Bloomberg (May 30, 2018), https://www.bloomberg.com/news/articles/2018-05-30/fed-releases-proposal-for-easing-volcker-rule-trading-limits. The statutory requirement for that Rule is found in section 619 of Dodd-Frank. 12 U.S.C. § 1851 (2012). Generally speaking, "[t]he Volcker rule . . . restricts U.S. banks from making certain kinds of speculative transactions on their own account and from investing in hedge funds." Michelle Price, *House passes bill to streamline 'Volcker Rule*', Reuters (Apr. 13, 2018), https://www.reuters.com/article/us-usa-congress-volcker/house-passes-bill-to-streamline-volcker-rule-idUSKBN1HK2QY. It was enacted to prevent the kinds of huge bank losses in 2008 arising directly from banks' proprietary and reckless speculative trades for their own accounts, thereby threatening the federally insured deposits within those banks. *Id.* The Fed's recent proposal does not try to alter Dodd-Frank's § 619. While the Fed's recent proposal has been criticized by market reformers as being too friendly to big U.S. banks, Mr. "Volcker himself weighed in, saying he welcomed efforts to simplify compliance with the rule he's credited with championing." Bain & Schmidt, *supra*. In this regard, Mr. Volcker has repeatedly emphasized that his original 2010 proposal was quite simple and was originally proposed in a 2010 three-page letter to President Obama. James B. Stewart, *Volcker Rule, Once Simple, Now Boggles*, Common Sense (Oct. 21, 2011), https://www.nytimes.com/2011/10/22/business/volcker-rule-grows-from-simple-to-complex.html. He has elsewhere said: "I'd write a much simpler [rule.] I'd love to see a four-page [rule] that bans proprietary trading and makes the board and the chief executive responsible for compliance." *Id*. However, the final Volcker Rule, as written separately by 5 different banking and market regulators, was about 1000 pages in length. *Fed Unveils Rewrite of 'Volcker Rule' Limits on Bank Trading*, Reuters (May 31, 2018), https://www.nytimes.com/reuters/2018/05/31/business/31reuters-usa-fed-volcker.html. As one Member of Congress noted: "I support the concept of the Volcker Rule, but these rules [as drafted by the 5 different regulatory agencies] are not going to be effective. We have taken something simple and made it complex. The fact that it's [1000] pages shows the banks pushing back and having it both ways." Stewart, *supr*a. (comments of Rep. Welch (D.-Vt.) Finally, while it is true that legislation to amend the Volcker Rule passed the House of Representatives in April 2018, it was that very legislation that a bi-partisan group of Senators refused to consider as part of the legislative effort to enact S.2155. Price, *supra*; see notes 386-90 *supra* and accompanying text. It is clear that any legislative effort to amend Section 619 would face very rough going in the U.S. Senate. In sum, a regulatory adjustment to Volcker Rule *regulations*, which has the sympathy of Mr. Volcker, is very different than trying to undo the Dodd-Frank *statutory* provisions for swaps regulation. That explains why no one is seriously proposing to amend Dodd-Frank's statutory swaps regulatory provisions

[393] *Id.*; Sylvan Lane, *Overnight Finance: Trump Adviser Now Backs New Glass-Steagall*, THE HILL (Apr. 6, 2017), http://thehill.com/policy/finance/overnights/327698-overnight-finance-cohn-backs-modern-glass-steagall-pelosi-no-deal; Elizabeth Dexheimer, *Cohn Backs Wall Street Split of Lending, Investment Banks*, BLOOMBERG (Apr. 5, 2017), https://www.bloomberg.com/news/articles/2017-04-06/cohn-said-to-back-wall-street-split-of-lending-investment-banks; Bess Levin, *Gary Cohn, Trump's Top Goldman Hire, Wants to Bring Back Glass-Steagall*, VANITY FAIR (Apr. 6, 2017), http://www.vanityfair.com/news/2017/04/gary-cohn-glass-stegall; Michael Corkery & Jessica Silver-Greenberg, *Trump and Warren Agree? Maybe, on Plan to Shrink Big Banks*, N.Y. TIMES (Apr. 6, 2017), https://www.nytimes.com/2017/04/06/business/dealbook/donald-trump-elizabeth-warren-big-banks.html?_r=0; Patrick Jenkins, *The Tangled Web of Gary Cohn, Goldman Sachs and Glass-Steagall*, FIN. TIMES (Apr. 10, 2017), https://www.ft.com/content/1cdae6d8-1b90-11e7-bcac-6d03d067f81f.

which was fully repealed in 1999,[394] was a New Deal response to the Great Depression that ring-fenced commercial banking with insured customer deposits from investment banks dealing in speculative investments.[395] Under a new Glass-Steagall-like scenario, U.S. bank holding company swaps dealers almost certainly would not be fully able to engage in swaps trading as they do today. Much of that trading, even under the most lenient pending Glass-Steagall proposals, would mostly be removed from a commercial bank with federally insured deposits, and the bulk of that trading would be left, *inter alia*, to investment banks and hedge funds ring-fenced from commercial banking.[396] The size of the latter banks would not be systemically important and their failure would likely be handled by, *inter alia*, the wind-down provisions within Dodd-Frank or by traditional bankruptcy proceedings.[397] The failure of these ring-fenced banks self-evidently would also not threaten customer deposits, because they would have so few or even none.

To be sure, there are varying perspectives on what such a "modern day" Glass-Steagall measure would look like. On April 6, 2017, Senators Elizabeth Warren, Democrat of Massachusetts, and John McCain, Republican of Arizona, introduced the "21st Century Glass-Steagall Act of 2017," which would, among other things, *separate* commercial and investment banks.[398] In

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[394] *Id.* (The result of the complete repeal of Glass-Steagall in 1999 sanctioned the rise "of so-called universal banking, which allows mainstream deposit-taking activities and riskier investment banking to take place under one roof.").

[395] Jordan Weissmann, *Trump's Top Adviser, the Former President of Goldman Sachs, Supports Bringing Back Glass-Steagall*, SLATE (Apr. 6, 2017), http://www.slate.com/blogs/moneybox/2017/04/06/donald_trump_s_top_economic_advisor_supports_bringing_back_glass_steagall.html.

[396] Jenkins, *supra* note 392.

Of course, it has been pointed out that because Goldman Sachs is not a "universal banker," the reinstatement of Glass-Steagall "would be a non-event for Goldman Sachs itself. In competitive terms, it would be a huge boost . . . . As Dennis Kelleher of Better Markets, a pro-regulation group put it: 'Most troubling about Mr. Cohn's possible embrace of Glass-Steagall are the potential benefits uniquely enjoyed by his former firm, Goldman Sachs.' Goldman Sachs, he says, 'would be kings of the financial work where [universal bank holding companies] couldn't compete." *Id.* (brackets in original).

[397] *See also* Barney Jopson, *US 'Too Big to Fail' Regime Set for Trump Overhaul*, FIN. TIMES (Feb. 21, 2018), https://www.ft.com/content/d08bc3ca-1705-11e8-9e9c-25c814761640 (describing Treasury Secretary Mnuchin's recent proposal to create, *inter alia*, a new category of Chapter 14 bankruptcy designed to make it easier to wind down collapsing megabanks outside of more traditional bankruptcy provisions as a recognition that existing Dodd-Frank wind down provisions will not work and will lead to calls for U.S. taxpayer bailouts of megabanks).

[398] S. 881, 115th Congress (2017). There is also a bipartisan "21st Century Glass-Steagall Act of 2017" effort in the House, led notably by Rep. Capuano (D-MA) and Rep. Jones (R-NC), H.R. 2585, 115th Congress (2017), as well as a related "Return to Prudent Banking Act of 2017" sponsored by fifty-eight representatives, including Reps. Kaptur (D-OH), Jones (R-NC), and Coffman (R-CO). H.R. 790, 115th Congress (2017). Additionally, Sen. Kennedy (R-LA) has also stated the need for policymakers to discuss the return of Glass-Steagall. Ian McKendry, *GOP Lawmaker Wants to Hear More About Glass-Steagall Return*, AM. BANKER (Jun. 7, 2017), https://www.americanbanker.com/news/gop-lawmaker-wants-to-hear-more-about-glass-steagall-return.

May, 2017, Treasury Secretary Mnuchin, in testimony to a Senate committee regarding the Warren and McCain bill, said he and the President are in favor of a "21st Century Glass-Steagall" (not referring to any Congressional bills) that contains "aspects of [the original Glass-Steagall] that may make sense," but they would not support a complete separation of commercial and investment banks.[399]

One prominent "third way compromise" gaining currency (and which sounds as if it may fall within Secretary Mnuchin's stated preference), is a law "modelled on [the U.K.'s] ring-fencing rules [that] will erect a barrier between retail and investment banking activities [.]"[400] One leading suggestion of this kind from Thomas Hoenig, former Vice Chairman of the Federal Deposit Insurance Corporation, "would be a 20 percent restriction on the funding an investment bank could source from the holding company."[401] However, Wall Street certainly would not cheer even a modest "third-way" compromise of this sort; nor would the risk of any kind of Glass-Steagall legislative rider be borne by these big swaps dealers to try to obtain complete Dodd-Frank swaps regulation relief.

Thus, for this reason as well, there is understandably considerable hesitancy on the part of the four huge, "systemically" risky U.S. bank holding company swaps dealers in advancing proposals to substantially unravel Dodd-Frank swaps regulations. Debate over that kind of legislation would almost certainly invite vigorous debate both in and out of Congress about the extent to which these large commercial banks should be separated from their investment arms, *i.e.,* reinstatement of a "modern day" Glass-Steagall to prevent future U.S. taxpayer bailouts.

Third, and probably most important, the big banks are reticent about seeking legislative relief from Dodd-Frank swaps regulation is because of the ease with which the big U.S. bank holding company swaps dealers can now evade at their will Dodd-Frank swaps regulation through the deguarantee and ANE loopholes.[402] The *de facto* (and largely unrecognized) repeal

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[399] *Treasury Secretary Clarifies Position on Glass-Steagall*, C-SPAN (May 18, 2017), https://www.c-span.org/video/?c4670278/treasury-secretary-clarifies-postion-glass-steagall.

[400] Patrick Jenkins & Barney Jopson, *Support Builds for Watered-Down Version of Glass-Steagall Law*, FIN. TIMES (Apr. 18, 2017), https://www.ft.com/content/4ca1c210-227f-11e7-8691-d5f7e0cd0a16.

[401] *Id.*

[402] *See supra* notes 403-51 and accompanying text.

of U.S. swaps regulation by these bank-created extraterritorial loopholes at each banks' exclusive discretion has the complete *de facto* effect of a substantial *de jure* statutory repeal without the accompanying dangers of, for example, a Glass-Steagall-like debate.

IX. The ISDA "Deguarantee" Loophole

As will be shown in detail below, a single footnote (footnote 563) within the 662 footnotes included in the CFTC's July 2013 guidance was unilaterally seized upon in August 2013 by ISDA and its swaps dealer members to carve a pathway to evade Dodd-Frank swaps regulation at their will. To understand how substantial this loophole is, one must first untangle the basic elements of the July 2013 Guidance, starting with the creation of an important distinction between swaps activities involving a "U.S. person"[403] and those involving only non-U.S. persons.

The 83 page, triple-columned, single-spaced July 2013 Guidance, makes "U.S. persons" in swaps trades subject to all of Dodd-Frank's swaps rules, regardless of the physical location of the swap execution.[404] The term "U.S. persons" includes the usual defining traits of such a term: the presence of natural U.S citizenship; corporate and other entities organized or with principal places of business in the U.S.; foreign entities owned by U.S. persons; and branch offices of U.S.

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[403] 78 Fed. Reg. 45,292 at 45,301–02 (". . . [t]he Commission's interpretation of the term 'U.S. person' would generally encompass: (1) persons (or classes of persons) located within the United States; and (2) persons that may be domiciled or operate outside the United States but whose swap activities nonetheless have a 'direct and significant connection with activities in, or effect on, commerce of the United States' within the meaning of CEA section 2(i)").

[404] *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,317 (July 26, 2013). Further, a securities industry group, unhappy with the July 2013 Guidance sued the CTFC to prevent the new rules from applying extraterritorially in the absence of a properly promulgated regulation addressing the rules' extraterritorial applications. The judge was unconvinced, holding that:

> The majority of plaintiffs' claims fail because Congress has clearly indicated that the swaps provisions within Title VII of the Dodd–Frank Act—including any rules or regulations prescribed by the CFTC—apply extraterritorially whenever the jurisdictional nexus in 7 U.S.C. § 2(i) is satisfied. In this regard, plaintiffs' challenges to the extraterritorial application of the Title VII Rules merely seek to delay the inevitable. The Court will not question the CFTC's decision to proceed in interpreting and applying Section 2(i) on a case-by-case basis through adjudication; nor will it set aside the CFTC's decision to promulgate the Cross–Border Action to announce its non-binding policies regarding the Title VII Rules' extraterritorial applications. Instead, the Court will only remand to the CFTC those Title VII Rules that are supported by inadequate cost-benefit analyses.

Sec. Indus. and Fin. Mkts. Ass'n, 67 F. Supp. 3d at 436. In August 2016, the CFTC published the cost-benefit analysis for the proposed rules in the Federal Register, allowing the eight rules to take effect. *See* Final Response to District Court Remand Order in *Sec. Indust. and Fin. Mkts. Ass'n, et al. v. U.S. C.F.T.C.*, 81 Fed. Reg. 54,478 (Aug. 16, 2016).

persons.[405] There can be no doubt that the four largest U.S. bank holding company swaps dealers are themselves U.S. persons.

The single most important concept within the guidance relates to whether Dodd-Frank applies to swaps executed outside the U.S. by a "foreign affiliate" of a U.S. Person. Under the guidance, if a foreign affiliate is "guaranteed" by a U.S. person parent, as had been the case in standard ISDA swaps contract language for about two decades, the foreign affiliate is subject to Dodd-Frank's swaps rules even if the trade is executed abroad.

A. The Deguarantee Footnote within the July 2013 Guidance

However, at first unbeknownst to the CFTC, that agency's decision to focus exclusively on a foreign affiliate *guarantee* unexpectedly let ISDA open the door for, *inter alia*, the four largest U.S. bank holding company swaps dealers to "deguarantee" their foreign "affiliates."[406] The July 2013 guidance was interpreted by ISDA to enable this loophole with a single and otherwise seemingly immaterial footnote (footnote 563 of the 662 footnotes within the guidance), which provides that U.S. swaps dealers can avoid Dodd-Frank's swaps rules, "if a non-U.S. swap dealer . . . relies on a *written declaration* from the [foreign] subsidiaries' parent that, under the swap, the subsidiary is *not guaranteed* with recourse by a U.S. person."[407] Footnote 563 is the *only* source cited for the "deguarantee loophole."[408]

B. ISDA Provides the "Deguarantee User's Guide" to Evade Dodd-Frank

On August 19, 2013, footnote 563 of the July 2013 Guidance was relied upon by ISDA to become a clear instruction to its members on how to deguarantee presently guaranteed foreign

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405 Better Markets Comment Letter on Cross-Border Application of Registration Thresholds (Dec. 19, 2016), https://www.bettermarkets.com/rulemaking/better-markets-comment-letter-cftc-cross-border-application-registration-thresholds-and.

406 78 Fed. Reg. 45,292 at 45324–27. A guaranteed affiliate ceases to have SD/MSP metrics applied to it when it no longer benefits from a guarantee by a U.S. Person.

407 *Id.* at 45,355 n.563. *See supra* note 351, explaining that for the deguarantee loophole to be perfected, the deguaranteed foreign bank subsidiary must be trading with a *non-U.S. person* counterparty. It is explained therein the ease with which a "U.S. person" counterparty can itself through its own intra-corporate maneuvering, deguarantee (or create a deguaranteed) foreign subsidiary to convert itself to a "non-U.S. person, thereby taking the swaps trade out of Dodd-Frank as the deguarantee loophole law is now conceived by the CFTC.

408 *See* Levinson, *supra* note 351.

subsidiaries of U.S. bank holding company swap dealers to avoid Dodd-Frank's swaps rules.[409] In fact, after ISDA's August 2013 instruction, according to one leading observer, "the [four] biggest U.S. banks [had] changed 'hundreds of thousands' of such swaps contracts" to provide for this deguarantee.[410]

The centerpiece of implementing this "loophole" can be found by referencing the original copyrighted, boilerplate of ISDA swaps contract documentation produced for its member swaps dealers. That boilerplate is referred to in detail above.[411] Since 1992, when a ISDA swaps customer contemplated executing a swap with a subsidiary of a parent U.S. bank holding company, it was commonplace for the parent to guarantee that subsidiary within the ISDA standardized and copyrighted "credit support annex."[412]

A key change to the ISDA documentation came on August 19, 2013, about a month after the CFTC July 2013 Guidance was finalized. At that time, unbeknownst to the CFTC, ISDA published, and made available to its swaps dealer membership, a standardized "Cross-border Swaps Representation Letter" (the "ISDA Cross-Border Letter").[413] The ISDA Cross-Border Letter relies on ISDA's interpretation of footnote 563 as having sanctioned the deguaranteeing of foreign subsidiaries by a simple pre-written standardized declaration.[414] In the prior twenty-one years that ISDA provided these copyrighted boilerplate documents to its members, it had never before contemplated form language deguaranteeing a U.S. swaps dealer's foreign subsidiary.

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409 *Id.*

410 *Id.*

411 *See supra* notes 85-91 and accompanying text; Master Agreement, International Swaps and Derivatives Association (1996) (Original publication and copyright 1992), http://mediacommun.ca-cib.com/sitegenic/medias/DOC/91928/2013-dodd-frank-isda-master-agreements-v2.pdf.

412 Credit Support Annex, Int'l Swaps and Derivatives Ass'n (1994), http://mediacommun.ca-cib.com/sitegenic/medias/DOC/91928/2013-dodd-frank-isda-credit-support-documentation-users-guides-and-guidelines.pdf; *see* INT'L SWAPS AND DERIVATIVES ASS'N, 2011 BEST PRACTICES FOR THE OTC DERIVATIVES COLLATERAL PROCESS 6 (2011); *see*, *e.g.* Christian Johnson, *Rehypothecation Risk*, DERIVATIVES WEEKLY (April 15, 2001); Christian Johnson, *Seven Deadly Sins of ISDA Negotiations*, GlobalCapital.com (Mar. 25, 2002), http://www.globalcapital.com/article/k662gjg9jlcw/seven-deadly-sins-of-isda-negotiations; Dennis M. Forster, *Standard Swaps Agreements Don't Insulate Users from Risk*, THE AMERICAN BANKER (June 13, 1994).

413 Cross-border Swaps Representation Letter, Int'l Swaps and Derivatives Ass'n (Aug. 19, 2013), http://www2.isda.org/attachment/NTgyNA==/Cross_Border_Rep_Letter_Final.doc.

414 *Id.*

Lest there be any confusion regarding the intent of the ISDA Cross-Border Letter, the preamble language on its first page reads:

> "On July 25, 2013, the CFTC published an "Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations" providing guidance as to when the CFTC will assert jurisdiction over swap transactions that have a non-U.S. element. This representation letter allows market participants to provide counterparties with status representations needed to determine whether compliance with various CFTC swap regulations is required by the Interpretive Guidance. The representations in this letter are solely for the purposes of making such determinations."[415]

ISDA then reduced the process of deguaranteeing foreign subsidiaries to a box-checking exercise, *i.e*., where a party would literally put a checkmark in a box next to the question titled "II (B) Guarantee Representations":

> "No U.S. Person Guarantees.
>
> > We hereby represent to you as of each time we enter into a Swap Transaction with you that, unless we have notified you to the contrary in a timely manner in writing prior to entering into such Swap Transaction, our obligations to you in connection with the relevant Swap are not, supported by any Guarantee (of which we are aware) other than any Guarantee provided by a person who we reasonably believe does not fall within any of the U.S. Person Categories and who we believe in good faith would not otherwise be deemed a "U.S. person" under the Interpretive Guidance."[416]

The ease with which the four big U.S. bank holding company swaps dealers could now reverse over two decades of past practice of guaranteeing subsidiaries to a new deguarantee contextualizes the flight of swaps trading from U.S. markets. It has been reported, for example, that the movement of the U.S. swaps market abroad is as high as 95% within certain kinds of swaps trading volume.[417] The problem, however, is that, in escaping Dodd-Frank's swaps rules by trading through newly deguaranteed foreign subsidiaries, the systemic risk to the U.S. economy slingshots back to the U.S. bank holding company lender of last resort: the U.S. taxpayer.

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[415] *Id.*

[416] *Id.*

[417] Levinson, *supra* note 351.

C. Deguaranteeing Does Not Eliminate Systemic Risk: U.S. Parent Banks and the U.S. Taxpayers Remain on the Hook

It is long-standing practice of corporate governance that when a parent entity has created a subsidiary engaged in high-risk activities, the parent entity offers assurances to third party partners/customers in the form of a downstream guarantee of the subsidiary.[418] The deguarantee loophole changes decades of common practice. For example, in 1992, the then-budding swaps market relied heavily on the assurances of guarantees as evidenced by the standardized Credit Support Annex to the ISDA Master Agreement.[419]

Now, in what is a several hundred trillion-dollar notional value swaps market, guarantees of swaps trading subsidiaries are suddenly no longer deemed a business necessity. This is certainly so because 90% of the U.S. swaps market as traditionally defined is handled by the four huge U.S. bank holding company swap dealers who, as the aftermath of the Great Recession shows, are generally understood to be backed by the U.S. government through U.S. taxpayer-funded bailouts.[420] Swaps counterparties to these huge U.S. bank holding company swaps dealers and their foreign affiliates know that these institutions are generally considered "too-big-to-fail," and thus an explicit guarantee from the parent is really no longer needed. As mentioned earlier, there is such certainty that these big banks will be rescued in a financial crisis that that understanding is embedded in the stock price of these banks.[421]

The ISDA deguarantee language is nothing more than a legal fiction. It does not in fact shield any parent U.S. bank holding company swaps dealer from the practical, real-world risk of a foreign subsidiary default. Were a U.S. bank to allow the failure of their de-guaranteed foreign subsidiary, the creditworthiness of its many other deguaranteed or guaranteed affiliates

418 *See generally* Casandra Jones Havard, *Back to the Parent: Holding Company Liability for Subsidiary Banks — A Discussion of the Net Worth Maintenance Agreement, the Source of Strength Doctrine, and the Prompt Corrective Action Provision*, 16 CARDOZO L. REV. 2353 (1995).

419 *See* Credit Support Annex, *supra* note 412.

420 *See supra* note 33 and accompanying text.

421 *Id*.

and subsidiaries,[422] and even the parent U.S. bank itself, would immediately suffer severe reputational damage, and that damage would manifest itself with that bank quickly being deemed a credit risk.[423] Thus, even without a guarantee, it is widely understood in financial circles that the foreign subsidiary has a *de facto* guarantee backed by the lender of last resort to the bank holding company: the U.S. taxpayer.

The CFTC acknowledged this fact when it said in the July 2013 guidance: "[e]ven in the absence of an explicit business arrangement or guarantee, U.S. companies may for reputational or other reasons choose, *or feel compelled*, to assume the cost of risks incurred by deguaranteed foreign affiliates."[424] As one market expert so aptly put it: "The market knows and relies on the unstated fact that the U.S. parent bank can and ultimately must bail out any purportedly unguaranteed subsidiaries to avoid the reputational and run risk associated with their failure."[425] The real effect is that using the "deguarantee" to evade Dodd-Frank means that "banks are again moving their risky derivatives trading . . . outside U.S. regulation, while increasing the risk that future losses will still come back home to the U.S. for the U.S. taxpayer bailouts – just as they did in 2008."[426] As then-CFTC Chairman Gensler also made clear: "[W]hen a run starts

[422] Former CFTC Chairman Gensler has pointed out that, "[t]he nature of modern finance is that financial institutions commonly set up hundreds, if not thousands, of 'legal entities' around the globe with a multitude of affiliate relationships." Gary Gensler, Chairman, Keynote Address on the Cross-border Application of Swaps Market Reform at Sandler O'Neill Conference (June 6, 2013) [hereinafter Gensler Address], http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-141.

[423] IMF, *Subsidiaries or Branches: Does One Size Fit All?*, IMF Staff Notes, at 4, 9, 20 (Mar. 7, 2011); *see* Daryl Montgomery, *Coming Soon from Europe: The Next Global Financial Crisis*, SEEKING ALPHA (July 7, 2016), http://seekingalpha.com/article/3987017-coming-soon-europe-next-global-financial-crisis ("Banks and Wall Street firms are somewhat unique among all companies in that they must maintain credibility among their peers. The loss of ability to perform financial transfers means instant death for them. Bear Stearns folded overnight in March 2008 because of this, even though it was hurrying to release its excellent first quarter earnings. Earnings, book value, PE, and other fundamental measures of a company's strength become instantly meaningless under such circumstances."); *see also* Greenberger & Waddington Letter, *supra* note 175.

[424] 78 Fed. Reg. 45,292 at 45294 (emphasis added).

[425] *Cross-Border Factsheet*, BETTER MARKETS (June 19, 2014) [hereinafter *Cross-Border Factsheet*], https://bettermarkets.com/sites/default/files/Cross-Border%20Guarantee%20Fact%20Sheet%206-19-14%20(2).pdf. This position is fully adopted by the CFTC as noted in the July 2013 Guidance stating, "[e]ven in the absence of an explicit business arrangement or guarantee, U.S. companies may for reputational or other reasons choose, or feel compelled, to assume the cost of risks incurred by foreign affiliates."). Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292 (July 26, 2013*); see also* Greenberger & Waddington Letter, *supra* note 175; Letter from Michael Greenberger, Prof., Univ. of Md., Carey Sch. of L. and Brandy Bruyere, Analyst, CHHS, Univ. of Md., to Melissa Jurgens, Sec'y, CFTC, RIN No. 3038-AD85 (Feb. 6, 2013) [hereinafter Greenberger & Bruyere Letter], https://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59149&SearchText; Letter from Am. for Fin. Reform, to Tim Massad, Chairman, CFTC, RIN 3038-AE54 (Dec. 19, 2016) [hereinafter Letter].

[426] *Cross-Border Fact Sheet*, *supra* note 425; *see also* Greenberger & Waddington Letter, *supra* note 202.

on any overseas affiliate or branch of a modern financial institution, risk comes crashing back to our shores."[427]

D. Incentives for U.S. Bank Swaps Dealers to "Deguarantee"

Financial markets, especially the markets for swaps, are global, as the worldwide financial crisis of 2008 made clear. Accordingly, at the September 2009 G20 Summit in Pittsburgh, it was agreed that all G20 countries would develop regulations for swaps according to a set of agreed upon regulatory principles that are now reflected within Dodd-Frank.[428]

The U.S. responded to the G20 call to action by enacting Dodd-Frank less than a year later.[429] Unfortunately, almost all of the remaining member nations failed to act on a timely basis. With the meltdown in the rear-view mirror, an international race-to-the-bottom of swaps regulation was therefore created under the seeming assumption that non-U.S. counterparties would choose to enter swaps transactions with foreign dealers under lax regulation to avoid, *inter alia*, the regulatory "bother" of Dodd-Frank. This attitude was claimed to pose a threat to the big U.S. bank holding company swaps dealers who, within that race-to-the-bottom, feared that they would be displaced as leaders of the worldwide swaps markets if they and their foreign subsidiaries were governed by Dodd-Frank.[430]

The claim of the Securities Industry and Financial Markets Association ("SIFMA"), the international banking industry's main lobbying group in*, inter alia*, Washington, D.C., was that for a U.S. bank holding company swap dealer to remain "competitive" in the global swaps market,

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[427] Gensler Address, *supra* note 422.

[428] *See* U.S. DEP'T OF TREAS., LEADERS' STATEMENT: THE PITTSBURGH SUMMIT 2 (2009), https://www.treasury.gov/resource-center/international/g7-g20/Documents/pittsburgh_summit_leaders_statement_250909.pdf ("We committed to act together to raise capital standards, to implement strong international compensation standards aimed at ending practices that lead to excessive risk-taking, to improve the over-the-counter derivatives market and to create more powerful tools to hold large global firms to account for the risks they take."); *id*.

[429] Dodd-Frank Wall St. Reform and Consumer Prot. Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). This act was signed into law July 21, 2010. *Id.*

See Robert Reich, *Wall Street's Global Race to the Bottom*, HUFF. POST (Oct. 4, 2010), http://www.huffingtonpost.com/robert-reich/wall-streets-global-race-_b_750239.html ("Squadrons of lawyers and lobbyists are not pressing the Treasury, Comptroller of the Currency, SEC, and the Fed to go even easier on the Street. Their main argument is if regulations are too tight, the big banks will be less competitive internationally.").

[430] FIN. REG. IN THE EU (Rainer Kattel et al. eds., 2015) (commenting on the "light touch" approach adopted by the British financial system).

it had to free its foreign subsidiaries from Dodd-Frank. "In private talking points drafted by the [SIFMA] . . . the industry [claimed] the de-guaranteeing practice is lawful and allows U.S. banks to compete on a level playing field with their foreign-based counterparts."[431]

However, the argument that U.S. banks would have suffered by losing competitive swaps battles to true foreign swap dealers because those U.S. banks would be subject to the Dodd-Frank framework is flawed. Many U.S. bank holding company swaps dealers left the swaps market since the 2008 meltdown, recognizing that swaps were deemed so financially insecure that the prudential banking regulators were hiking capital requirements in direct proportion to a U.S. bank holding companies' swaps trading exposure.[432] Leaving the swaps market, therefore, is not necessarily as financially suicidal as described by, *inter alia*, SIFMA.

Moreover, one of the major reasons U.S. bank holding company swap dealers have been found by regulators, legislative bodies, and reputable academics to be systemically "important" (or risky) *is* because of the very volatility of the swaps market in which they trade. Warren Buffet famously called swaps, "weapons of mass financial destruction."[433] Buffet has also said that

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[431] Silla Brush, *Wall Street Faces Scrutiny of Tactic to Evade Swaps Rules*, BLOOMBERG (July 31, 2014), https://www.bloomberg.com/news/articles/2014-07-31/wall-street-faces-new-u-s-scrutiny-of-derivatives-tactic.

[432] Olivia Oran, *Morgan Stanley's Commodities Head Swaps Swagger for Small and Smart*, REUTERS (Dec. 5, 2016), http://www.reuters.com/article/us-morgan-stanley-commodities-idUSKBN13U1FX; Gregory Meyer, *Goldman Warns Federal Reserve over Commodity Trading Rules Fallout*, FIN. TIMES (Feb. 22, 2017), https://www.ft.com/content/8f345610-f91c-11e6-bd4e-68d53499ed71.

[433] Warren Buffet, *Edited Excerpts From Berkshire Hathaway Annual Report for 2002*, http://www.fintools.com/docs/Warren%20Buffet%20on%20Derivatives.pdf; *see also* Michael Snyder, *Warren Buffet: Derivatives Are Still Weapons of Mass Destruction and "Are Likely to Cause Mass Trouble"*, ETF DAILY NEWS (June 22, 2015), http://etfdailynews.com/2015/06/22/warren-buffett-derivatives-are-still-weapons-of-mass-destruction-and-are-likely-to-cause-big-trouble (offering Buffet's reaffirmed sentiment, thirteen years later, that "at some point [derivatives are] likely to cause big trouble"); *see* ERIC HELLEINER & STEFANO PAGLIARI, THE G20 LEADERS' SUMMIT AND THE REG. OF GLOBAL FIN.: WHAT WAS ACCOMPLISHED? (2008), http://www.stefanopagliari.net/helleiner-pagliari_-_the.pdf; *Id.* at 4-5:

> The G20 Leaders' Summit has also made commitments to bring order in the market for credit default swaps (CDS), a derivatives market involving contracts for insurance against bond defaults. These contracts have mainly been traded "over-the-counter" (OTC), that is, they have been negotiated privately between the buyer and the seller of the insurance without a formal clearinghouse or exchange that could minimize counter-party risk and force margin requirements for all contracts. This market grew at an astonishing speed over the last decade and regulators left it unchecked. In 2000, for example, the US Congress voted to exempt the OTC markets from oversight by the US futures regulator.
>
> While these contracts were seen as beneficial instruments to spread default risk, they now stand accused of having exacerbated the current crisis. Warren Buffett's famous description of derivative as "weapons of mass destruction" is now often repeated. The insurance giant American International Group (AIG) had to be rescued by the US Treasury after it had issued US$440 billion in swaps to cover defaults on debt. The opacity of the market has also contributed to uncertainty. In the aftermath of the default of the US investment bank Lehman Brothers, both the total amount of credit default swaps on its debt and the hands in which these contracts ended were unknown, and these knowledge gaps heightened the panic in the financial markets.

to the extent that swaps are thought to hedge the risk of underlying risky investments, *e.g.*, risky loans, the answer is not to make risky loans in the first place.[434]

To that end, the U.S. taxpayers should not become the *de facto* guarantor of risk for these megalithic U.S. banks embroiled in trillions of dollars of historically risky and poorly regulated swap transactions. Furthermore, the "competitive positioning" advanced by these U.S. banks and their lobbyists that so consumes this banking rhetoric is entirely at the expense of U.S. taxpayers. As such, recognizing that swaps are inherently dangerous instruments, especially in the volumes transacted by these huge U.S. bank holding company swaps dealers, the supposed "loss" of swaps business would be, if fulfilled, arguably to the betterment of the U.S. and world economies, and certainly better for U.S. taxpayers.

The deguarantee loophole footnote provided the perfect foil for ISDA and, *inter alia*, these large U.S. bank holding company swap dealers to engage in regulatory arbitrage. Sources "with knowledge of the situation" maintain that U.S. banks removed foreign affiliate guarantees for the express purpose of not "get[ting] caught by U.S. regulations."[435]

E. CFTC's Belated, and Now Likely Permanently, Unsuccessful Attempt to End the Deguarantee Loophole

In early 2014, press reports began to surface that CFTC staff at that time first learned of, and reported to unsuspecting CFTC Commissioners that, the large U.S. swaps dealers were using a "deguarantee loophole" to move trades from domestic U.S. parents or affiliates to newly

Most regulatory institutions around the world, including the FSF, have begun calling for OTC derivatives transactions to be recorded and cleared through a clearinghouse standing between the parties of the trade. Even the International Swaps and Derivatives Association (ISDA), the most important private industry organization in the sector, has shifted its position. After long resisting tighter public controls over OTC derivatives, the ISDA recently welcomed the creation of a centralized clearinghouse, while developing a series of protocols to facilitate net settlement of credit default swaps on the debt of Lehman Brothers, Washington Mutual, Freddie Mac and Fannie Mae."

434 *See e.g.*, Bansi R. Shah, *Risk Management Techniques: Do They Pay Off?*, 5 INDIAN J. APPLIED RESEARCH 257 (2015), https://www.worldwidejournals.com/indian-journal-of-applied-research-(IJAR)/file.php?val=March_2015_1426582797__72.pdf.

435 Katy Burne, *Big U.S. Banks Make Swaps a Foreign Affair*, WALL. S. J. (Apr. 27, 2014), https://www.wsj.com/news/article_email/SB10001424052702304788404579520302570888332-lMyQjAxMTA0MDIwODEyNDgyWj.

"deguaranteed" foreign subsidiaries to evade application of Dodd-Frank.[436] As the year progressed, then CFTC Chairman Massad, who had shortly before assumed the CFTC chair, began to decry the practice of deguaranteeing as a pathway to escape Dodd-Frank.[437]

F. The CFTC's First Formal Response to the Deguarantee Loophole: Extraterritorial Application of the Rules for Margin for Uncleared Swaps

The first formal CFTC response to the loophole was a new rule for cross-border application of its Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants ("Cross-Border Margin Rule") proposed on July 14, 2015, and made final in May 2016.[438] The CFTC stated in the proposed rule that it "is aware that some [U.S. Swaps Dealers] removed guarantees in order to fall outside the scope of certain Dodd-Frank requirements" and that "[t]he [newly] proposed coverage [in the new proposed rule] of foreign subsidiaries of a U.S. person as a 'Foreign Consolidated Subsidiary' ["(FCS")] . . . would address the concern that even without a guarantee . . . foreign subsidiaries of a U.S. person with a substantial nexus to the U.S. financial system [would henceforth be] adequately covered by the [new] margin requirements."[439]

The final Cross-Border Margin Rule adopted the FCS concept and definition from its proposed version. An FCS is

> "a non-U.S. covered swap entity ("CSE") in which an ultimate parent entity that is a U.S. person has a controlling financial interest, in accordance with U.S. GAAP, such that the U.S. ultimate parent entity includes the non-U.S. CSE's operating

[436] David Aron & Ken McCracken, *CFTC's Anti-Evasion Rule Under Dodd-Frank Brought to Forefront by "De-guaranteeing" Activity*, 36 NO. 6 FUTURES & DERIVATIVES L. REP. NL 2, fn. 1 (June 2016) (quoting Peter Madigan, *100% Not Guaranteed: US Banks Quizzed Over Affiliates*, RISK.NET (July 28, 2014)) ("quoting a 'senior' CFTC source, who noted '[t]here is no formal investigation into the de-guaranteeing of these affiliates' and that then-Acting Chairman Wetjen 'instructed staff to gather some facts . . . [, which] isn't the same as asking the enforcement division to initiate an investigation'"); *see also*, Levinson, *supra* note 351.

[437] Aron & McCracken, *supra* note 436 (citing Andrew Ackerman & Scott Patterson, *CFTC to Scrutinize Swaps Loophole*, WALL ST. J., (Sept. 5, 2014)) (reporting Massad's concerns that "activity that takes place abroad can result in the importation of risk into the U.S. . . . infecting the parent company in possibly destabilizing ways" and additionally that the CFTC "plans to scrutinize U.S. Banks that are shifting some trading operations overseas to avoid tough CFTC rules").

[438] Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 80 Fed. Reg. 41,375, 41,385 (July 14, 2015).

[439] *Id.* at 41,385.

> results, financial position and statement of cash flows in the U.S. ultimate parent entity's consolidated financial statements, in accordance with U.S. GAAP."[440]

Said more simply, an affiliated entity – U.S. or otherwise – whose performance is consolidated within its U.S. parent company's books is subject to the new CFTC margin rules for uncleared swaps, regardless whether the affiliate is deguaranteed by the parent. As such, the effect of the final Cross-Border Margin Rule is that it addresses the deguaranteeing problem by "subject[ing] to U.S. margin rules for uncleared swaps both (1) uncleared swaps of non-U.S. CSEs [covered swap entity] guaranteed by a U.S. person *and* (2*) uncleared swaps of FCSs [foreign consolidated subsidiary]*."[441]

Although this shift is important, the Cross-Border Margin Rule *only* applies to certain – not all – *margin* requirements and it does not apply to the twelve other types of Dodd-Frank swaps regulatory tools discussed above.[442]

Of course, those swaps that moved, under the deguarantee contract clause provided in the August 2013 ISDA Cross-Border letter, from the U.S. swaps dealer parent or that parent's U.S. affiliate to their newly deguaranteed foreign subsidiaries in trades with "non-US. Persons" would generally *not* be cleared pursuant to Dodd-Frank (since the motivation for moving swaps to a deguaranteed foreign subsidiarity was to evade Dodd-Frank). As such, the CFTC January 2016 final rule on margin for uncleared swaps would have brought foreign subsidiary swaps completely back under Dodd-Frank margin requirements. If subject to Dodd-Franks' margin requirements, the amounts posted for margin would therefore also be included, *inter alia*, in the U.S. prudential regulators' calculations for that capital that must be held in reserve under Dodd-

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440 *Id.*

441 *Id*. at 41,385 (emphasis added).

442 For a discussion of Dodd-Frank swaps regulatory tools, see *supra* notes 300-23 and accompanying text. For the CFTC's final rule on margin for uncleared swaps, see Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 Fed. Reg. 636, et seq. (January 6, 2016) (final rule).

Frank for U.S. bank holding company swaps dealers.[443] As a result, the May 16 final rule "recaptured" those "foreign" uncleared swaps, placing them back under Dodd-Frank margin and capital reserves requirements.

As shown in detail below[444], in a CFTC concession designed to head off a threatened "trade war" over swaps by, *inter alia*, the EU (supported by, *inter alia*, big U.S. swaps dealers), shortly after the CFTC's January 2016 margin for uncleared swaps rule was adopted, the CFTC uncleared margin rule was substantially and permanently preempted by the CFTC's later adoption of yet another self-created CFTC exemption from Dodd-Frank swaps rules: *i.e.,* the wholly made up doctrine of "substituted compliance." Under that doctrine, *inter alia,* these foreign subsidiaries' uncleared swaps that were originally thought to be brought back into Dodd-Frank's collateralization regime by the CFTC's cross border ruling for uncleared swaps, were instead governed by the "substituted" and much weaker EU and Japanese margin rules for uncleared swaps; and thus, once again, removed from Dodd-frank oversight.[445]

G. The Proposed CFTC Rules and Interpretations to End the Deguarantee and ANE Loopholes

The CFTC finally (more than three years after ISDA's deguarantee instruction to its members) recognized that it must address *completely* the deguaranteeing of subsidiaries as it applies to all thirteen of the Dodd-Frank swaps regulatory tools. On October 18, 2016, the CFTC proposed new rules and interpretations that fully recognized the nature of modern finance, i.e., where "large financial institutions typically conduct their business operations through a highly integrated network of business lines and services conducted through multinational branches or subsidiaries that are under the control of the ultimate parent entity."[446]

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443 *See* Capital Requirements of Swap Dealers and Major Swap Participants, 81 Fed. Reg. 91252 (Dec. 16, 2016).

444 For a full discussion of "substituted compliance" doctrine and its use by the CFTC, see *supra* notes 474- 577 and accompanying text. For a full discussion of the EU's threatened swaps "trade war" with the United States, see *supra* notes 518-529 and accompanying text.

445 *See e.g.* Comparability Determination for the European Union: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 82 Fed. Reg. 48394-02 (Oct. 18, 2017); Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 63376-01 (Sept. 15, 2016).

446 Cross-Border Application of the Registration Thresholds and External Business Conduct Standards Applicable to Swap Dealers and Major Swap Participants, 81 Fed. Reg. 71,946, 71,950 (Oct. 18, 2016). This proposed rule made clear that where Dodd-Frank applied extraterritorially, the CFTC's business conduct standards, dealing with protections to non-SDs and MSPs were to be applied, including protections of due diligence, disclosure, fair dealing and anti-fraud requirements. *Id.*

The CFTC detailed the swaps operations of, *inter alia*, Goldman and Citigroup, noting "the current swap market is global in scale and characterized by a high level of interconnectedness among market participants, with transactions negotiated, executed, and arranged between counterparties in different jurisdictions, (and booked and managed in still other jurisdictions)."[447] The CFTC concluded "market realities suggest that a cross-border framework focusing *only* on the domicile of the market participant or location of counterparty risk would fail to effectively advance the policy objectives of the Dodd-Frank swap reforms, which were aimed at increasing market transparency and counterparty protections and mitigating the risk of financial contagion in the swap market."[448]

The CFTC clearly provided that "[a] failure to treat these [foreign] entities the same in this context could provide a U.S. financial group with an opportunity to avoid SD . . . registration by conducting relevant swap activities through unregistered [foreign affiliated] entities."[449] Accordingly, the CFTC, in its *proposed* rule and interpretations,[450] adopted the definition and use of FCS that it previously used in its final May 2018 Cross-Border Margin Rules as being applicable to *all* extraterritorial applications of Dodd-Frank's swaps rules. These consolidated foreign affiliates, it concluded, must therefore be subject to Dodd-Frank swaps rules whether guaranteed or not.

H. Yet Another Extraterritorial Loophole Discovered: ANE

Through the October 18, 2016 CFTC proposed rule-making, the CFTC highlighted yet another loophole adopted unilaterally, *inter alia*, by U.S. bank holding company swaps dealers in the application of the deguarantee doctrine. The CFTC squarely addressed the fact that swaps ultimately assigned to deguaranteed foreign subsidiaries had often been "arrange[d] negotiate[d], or execute[d]" ("ANE") by the U.S. bank holding company swap dealer's personnel (or

[447] *Id*. at 71,946.

[448] *Id.* at 71,948.

[449] *Id*. at 71,951.

[450] *Id.* at 71,973.

the personnel of the foreign deguaranteed subsidiary) *in the United States by U.S. bank personnel within the bank)* and only then "assigning" the fully executed trade to a newly deguaranteed foreign subsidiary.[451] Specifically, the CFTC stated:

> "In the Commission's view, and as further explained below, arranging, negotiating, or executing swaps are functions that fall within the scope of the 'swap dealer' definition. That the counterparty risks may reside primarily outside the United States is not determinative. To the extent that a person uses personnel located in the United States (whether its own personnel or personnel of an agent) to arrange, negotiate, or execute its swap dealing transactions, the Commission believes that such person is conducting a substantial aspect of its swap dealing activity within the United States and therefore, falls within the scope of the Dodd-Frank Act."[452]

This ANE practice further shows that U.S. bank holding company swaps dealers were treating newly deguaranteed foreign affiliates as mere shells; *i.e.,* channeling swaps business through the foreign subsidiary entity without any real need for the swaps being "executed" in the claimed foreign jurisdiction.

I. The CFTC's Proposed Rejection of the Deguarantee and ANE Loopholes Will Almost Certainly Never Be Finalized

President Trump has made clear that he wants to "roll back" Dodd-Frank.[453] President Trump has also nominated, and the Senate has confirmed, CFTC Commissioner Giancarlo as the new chairman of the CFTC.[454] Mr. Giancarlo worked at a brokerage active in derivatives before joining the CFTC in 2014. As a CFTC commissioner, Chairman Giancarlo had a record of being an

451 *Id.*

452 *Id.*

453 Ben Protess & Julie Hirschfeld Davis, *Trump Moves Back Obama-Era Financial* Regulations, N.Y. TIMES (Feb. 3, 2017), https://www.nytimes.com/2017/02/03/business/dealbook/trump-congress-financial-regulations.html?_r=1.

454 Barney Jopson & Ben McLannahan, *Trump Appointee Gary Cohn to Stay Clear of Goldman Matters*, FIN. TIMES (Feb. 23, 2017), https://www.ft.com/content/f83b253e-f9a4-11e6-9516-2d969e0d3b65; Benjamin Bain & Robert Schmidt, *Trump May Tap Republican Commissioner to Lead Swaps Regulator*, BLOOMBERG (Nov. 11, 2016), https://www.bloomberg.com/news/articles/2016-11-11/trump-may-tap-republican-commissioner-to-lead-swaps-regulator.

"outspoken critic"[455] of many CFTC Dodd-Frank rules.[456] While as shown above,[457] wholesale statutory reform of Dodd-Frank swaps statutory provisions to the benefit of the biggest U.S. banks is not in the offing, it is also expected that "[c]ontroversial pending [swaps] rules [like closing the deguarantee loophole] are unlikely to be finalized anytime soon."[458]

It therefore seems a certainty that the October 2016 CFTC proposal overturning the deguarantee and ANE loopholes will not be finalized by the CFTC during a Trump Administration. Therefore, the deguarantee and ANE loopholes will remain available, *inter alia*, to the four dominant U.S. bank holding company swap dealers, each of which has been deemed systemically risky; each of which has already been bailed out by U.S. taxpayers during the Great Recession; and each of which in combination now controls 90% of the U.S. swaps market as traditionally defined. Moreover, these U.S. bank holding company swaps dealers will be able to arrange, negotiate and execute these swaps in the U.S. with U.S. personnel before assigning the swaps to the newly de-guaranteed foreign subsidiary.

X. The Deguaranteeing of Foreign Subsidiaries Even When Swaps Are Executed in the U.S. is a Self-Evident "Evasion" of Dodd-Frank

As shown above,[459] Dodd-Frank's extraterritoriality provision, by its plain language, applies that statute's swaps regulatory regime to "foreign" swaps transactions that are designed to "evade" Dodd-Frank. It is self-evident that the four parent U.S. bank holding company swaps dealers have no other apparent or rational reason to have swaps assigned to a newly deguaranteed foreign subsidiary other than to afford opportunities to *evade* Dodd-Frank. This is seen even more clearly by the CFTC's recognition that these "foreign" swaps transactions are often fully arranged, negotiated and executed by U.S. bank personnel in the U.S. within the parent or

455 *See* Jopson & McLannahan, *supra* note 455.

456 Ben Protess, *Trump Picks a Regulator who Could Help Reshape Dodd-Frank*, N.Y. Times (Mar. 14, 2017), https://www.nytimes.com/2017/03/14/business/dealbook/cftc-christopher-giancarlo-futures-regulation.html.

457 *See supra* notes 364-402 and accompanying text.

458 Annette L. Nazareth & Gabriel D. Rosenberg, *Eight US Regulatory Predictions for 2017*, FIN. TIMES (Jan. 13, 2017), https://www.ft.com/content/79955066-d81f-11e6-944b-e7eb37a6aa8e.

459 *See supra* notes 325-47 and accompanying text.

affiliate domestic banks before they are "assigned" to a newly deguaranteed "foreign subsidiary"; and a recent precedent of the U.S. Court of Appeals for the Second Circuit strongly suggests that the "execution" of these swaps in the U.S. itself constitutes a "domestic" (and not an extraterritorial) transaction even if the swap is later assigned to a foreign entity and thus Dodd-Frank would fully apply.[460]

To implement the anti-evasion component of the extraterritorial provision, the CFTC, on August 13, 2012, promulgated Regulation 1.6 within its "Swap Adopting Release."[461] Regulation 1.6 defines "evasion" in the cross-border context as: (1) conducting activities outside of the U.S. to "willfully evade or attempt to evade" any portion of the Dodd-Frank swaps rules; and (2) the *form* of those activities (agreements, documents, contracts) shall not be dispositive to the question of evasion.[462]

The CFTC provided interpretive guidance[463] as a part of Regulation 1.6, in which that agency adopted a "principles-based approach" to determine evasion.[464] Among these principles, the CFTC embraced this concept:

> "[T]he structuring of instruments, transactions, or entities to evade the requirements of the Dodd-Frank Act may be 'limited only by the ingenuity of man.' Therefore, the CFTC will look beyond the manner in which an instrument, transaction, or entity is documented to examine its actual substance and purpose to prevent any evasion through clever draftsmanship—an approach consistent with the CFTC's case law in the context of determining whether a contract is a futures contract and the CFTC's interpretations in this release regarding swaps."[465]

By focusing the inquiry on the "substance and purpose" of the underlying swaps transactions or swaps entities, the CFTC expressly avoided being trapped by the words within swaps

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460 7 U.S.C. § 2(i); *see also* Painter, *supra* note 336, at 2–3. *see also Choi* v. *Tower Research Capital LLC*, No. 17-648 (2d Cir. March 28, 2018).

461 Anti-Evasion, 17 C.F.R. § 1.6 (Aug. 2012).

462 *Id.*

463 Swaps Adopting Release, 77 Fed. Reg. 48,208, 48,298 (Aug. 13, 2012).

464 *Id.*

465 *Id.* at 48,300 (internal citations omitted).

documentation and allowed itself to focus on the real underlying motive for the form of execution, as well as its economic impact.[466] In this regard, the CFTC has said: "[W]here a consideration of all relevant facts and circumstances reveals the presence of *a* purpose that is *not* a legitimate business purpose, evasion may exist."[467]

In applying this "substance and purpose" test to the practice of deguaranteeing foreign subsidiaries, there is an unanswerable case that deguaranteeing is willful evasion.[468] As the data cited above demonstrates,[469] many of the transactions moved abroad by U.S. bank holding company swaps dealers had previously been executed within the United States, thereby self-evidently showing that the real purpose of these transactions is to afford the chance to evade Dodd-Frank. Indeed, neither ISDA nor the deguaranteeing swaps dealers themselves have offered any explanation for the transfer abroad of what were, and what could be, U.S. swaps trades except for "candidly and openly reason[ing] that if they stripped out the word 'guarantee' and equivalent terms [from the ISDA swaps contract language], they could avoid the CFTC [swaps] rules."[470]

They acknowledge that the "deguaranteeing" strategy is premised upon the unsupported general allegation that "[i]nternational clients threatened to take their business to non-U.S. banks in order to avoid the new American rules . . . ."[471] However, "evading" Dodd-Frank as a competitive business strategy cannot justify evading the very provisions of that statute that are central to preventing a repeat of worldwide economic chaos and a U.S. taxpayer multi-trillion dollar intervention on those banks behalf. Indeed, the "legitimate business purpose" test

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466 *Id.; see also* Aron & McCracken, *supra* note 436, at 1.

467 77 Fed. Reg. 48,208 at 48,302 (emphasis added). Legitimate business purposes are evaluated on a case-by-case basis where the CFTC considers common industry practices and accepted business routines. Further related to the concept of legitimate business purpose, the CFTC has advised that regulatory cost avoidance is not *de facto* evasion; the CFTC even went so far as to say that legitimate business purposes include weighing all manner of costs; regulatory being among them. *See* Aron & McCracken, *supra* note 354, at 1.

468 77 Fed. Reg. 48,208 at 48,301 (stating "to the extent a purpose in structuring an entity or instrument or entering into a transaction is to evade requirements of Title VII with respect to swaps, the structuring of such instrument, entity, or transaction may be found to constitute willful evasion.).

469 *See supra* notes 352, 417 and accompanying text.

470 Levinson, *supra* note 351 (emphasis added).

471 *Id.* (clarification provided).

itself is nowhere mentioned in Dodd-Frank, much less authorized as a cure for otherwise banned behavior. Moreover, the CFTC interpretations of "evasion" expressly recognize that masking evasion as a legitimate business concern is flatly in conflict with one of the fundamental purposes of Dodd-Frank.[472]

Moreover, the CFTC "evasion" guidance itself identifies economically irrational behavior as presumptively an "[il]legitimate business purpose."[473] The irrationality of the ISDA-driven deguaranteeing box-checking process[474] is reinforced by the fact that neither the "foreign" subsidiary nor the subsidiary's counterparty, both of which lose the benefit of the guarantee, are compensated for accepting the economic risk assumed by deguaranteeing. The only "benefit" derived from the deguarantee transaction is that given to the U.S. parent, which escapes application of Dodd-Frank.

In sum, because "deguaranteeing" is clear-cut evasive behavior, these swaps transactions, even if executed abroad are, for this reason as well, subject to Dodd-Frank by the clear "evasion" terms of the extraterritorial provision in that statute.

XI. Dodd-Frank Swaps Rules Can Still Be Avoided by Even CFTC-registered Guaranteed Foreign Affiliates Using the CFTC Created Doctrine of "Substituted Compliance"

Even where a non-U.S. person *is* required by Dodd-Frank's extraterritorial provision to comply with Dodd-Frank, the CFTC's July 2013 guidance creates out of whole cloth a *further* exemption from the application of Dodd-Frank: the so-called "substituted compliance" doctrine. "Substituted compliance" are words found neither in Dodd-Frank nor in its legislative history.[475] The doctrine is wholly based on the CFTC's adoption of an unrelated and otherwise legally irrelevant "international comity" test, which, as used by the CFTC in this context, has no basis in U.S. law.

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472 Aron & McCracken, *supra* note 436.

473 *Id*.

474 *See supra* note 416 and accompanying text.

475 Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 Fed. Reg. 45,292, 45,340–42 (July 26, 2013).

"Substituted compliance," as created by the CFTC, is designed to avoid purported conflicts between Dodd-Frank and a conflicting swaps regulatory scheme of the foreign country in which the swaps transaction was executed.[476] In other words, if a foreign swaps transaction is otherwise required by Dodd-Frank's extraterritorial provision to be subject to Dodd-Frank, the CFTC has created a "legal fiction" to make that agency free to ignore Dodd-Frank and accept, under "substituted compliance", a foreign government's—rather than U.S.—swaps regulations.

Under the "substituted compliance" doctrine, the CFTC, upon application by any one of a broad group of stakeholders, determines whether foreign swaps rules at issue are, "comparable to and as comprehensive as the requirements of the Dodd-Frank Act," even if the rules are not "identical" to that U.S. law.[477] Entities entitled to request such a comparability determination from the CFTC include: foreign regulators; a non-U.S. entity or group of non-U.S. entities; a U.S. bank that is*, inter alia*, an SD with respect to its own foreign entities, a trade association, or other group on behalf of similarly-situated entities.[478]

Determinations when compliance with a foreign rule may be "substituted" for Dodd-Frank are made on a requirement-by-requirement basis, across the thirteen categories of Dodd-Frank's swaps regulatory rules.[479] In other words, the CFTC may, for example, allow substituted compliance for one of the thirteen Dodd-Frank swaps regulatory requirements, but apply Dodd-Frank for all other requirements.[480] Finally, and of great import here is, once a comparability decision has been made by the CFTC to rely on a foreign country's swaps rule (rather than a

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476 *Id.*

477 *Id.* at 45,342–43; *see also id.* ("After receiving a submission from an applicant, the resulting comparability determination would be made by the Commission with regard to each of the 13 categories of regulatory obligations, as appropriate."). The categories are: (i) capital adequacy; (ii) chief compliance officer; (iii) risk management; (iv) swap data recordkeeping; (v) swap data repository reporting and large trader reporting; (vi) clearing and swap processing; (vii) margining and segregation for uncleared swaps; (viii) trade execution; (ix) swap trading relationship documentation; (x) portfolio reconciliation and compression; (xi) real-time public reporting; (xii) trade confirmation; and (xiii) daily trading records. *Id.*

478 *Id.* at 45,344.

479 *See supra* notes 308-11 and accompanying text (listing the thirteen regulatory topics).

480 78 Fed. Reg. 45,292 at 45,343. In cases where the CFTC permits substituted compliance, the Commission retains its examination and enforcement authorities. *Id.* at 45,342. It is important to note however, that if a substituted compliance regimen is in play, the CFTC's examination and enforcement authorities are largely a mirage. The normal hooks that the CFTC would use to assert its authority may not be present, e.g., the SD may not even be registered.

Dodd-Frank rule), that decision is *binding precedent* in that it will automatically apply to all subsequent swaps transactions, of any swaps trade or by any swaps traders within the foreign jurisdiction.[481]

A. "International Comity" is the CFTC's Only Rational for "Substituted Compliance"

Again, the doctrine of "substituted compliance" is found nowhere in Dodd-Frank or its legislative history. The CFTC's entire legal underpinning for its invented "substituted compliance" rule is the doctrine of "international comity,"[482] a term also not found within Dodd-Frank. The reason given by the CFTC for following the international comity doctrine is because, *inter alia,* the European Union ("EU"), the United Kingdom ("U.K."), and Japan vigorously protested when the CFTC contended that "too-big-to-fail" U.S. swaps dealers were, under the plain language of the Dodd-Frank extraterritorial swaps provision, subject to that U.S. statute even where swaps trades were conducted abroad.[483]

Foreign countries, actively supported by ISDA and U.S. swaps dealers, were offended that their own laws would not apply to swaps executed in their countries, even if by U.S. persons.[484] Allegations of "sharp elbows"[485] by U.S. regulators were almost certainly levelled

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481 *Id*. at 45,345 ("Once a comparability determination is made for a jurisdiction, it will apply for all entities or transactions in that jurisdiction to the extent provided in the determination, as approved by the Commission.").

482 *See generally* William S. Dodge, *International Comity in American Law*, 115 COLUM. L. REV. 2071 (2015), http://dx.doi.org/10.2139/ssrn.2558175.

483 *See* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 C.F.R. § 45,292 (2013); *see also* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 C.F.R. § 45,300 (2013) (setting forth the CFTC's guidance regarding Title VII's extraterritorial application); *see also* Interpretive Guidance and Policy Statement Regarding Compliance with Certain Swap Regulations, 78 C.F.R. § 45,371-72 (2013) (describing the cross-border rules as "overbroad" and without adequate grounding in the "direct and significant" standard as articulated by CFTC Commissioner Scott D. O'Malia in his dissenting statement).

484 *See* Eileen Bannon, *The Extraterritorial Reach of Derivative Regulation under Dodd-Frank,* HOLLAND & KNIGHT (Apr. 12, 2013), https://www.hklaw.com/publications/The-Extraterritorial-Reach-of-Derivative-Regulation-Under-Dodd-Frank-04-12-2013/.

> "In 2009, the members of the G-20 agreed that: (i) the OTC derivatives contracts should be reported to trade repositories; (ii) standardized OTC derivatives contracts should be cleared through central counterparties by the end of 2012; and (iii) non-centrally cleared contracts should be subject to higher capital requirements. In light of such reform initiatives, there has been substantial concern that regulation be coordinated on an international basis . . . . Regulatory requirements for derivatives have advanced to different levels in various jurisdictions, and the Commodities Future Trading Commission (CFTC) is the first regulator to have attempted to define its jurisdictional reach. . . . The CFTC states that it will use an outcomes-based approach to determine whether the foreign requirements are designed to meet the same regulatory objectives, and anticipates a robust and ongoing coordination and cooperation between the CFTC and its foreign counterparts."

485 *Id.*

against the then-CFTC Chairman Gensler, who steadfastly maintained that the extraterritorial provision within Dodd-Frank applying Dodd-Frank to swaps executed abroad by*, e.g.,* the four big U.S. bank holding company swaps dealers, prevents U.S. taxpayers from having to once again make multi-trillion dollar bailouts of those U.S. systemically risky institutions, and thus otherwise saves the U.S. and worldwide economy from another calamitous meltdown.[486]

Once Mr. Gensler left the Commission at the end of 2013, however, little deference was thereafter given to the U.S. taxpayer's plight as the lender of last resort to those very large, systemically risky U.S. bank holding company swaps dealers. Rather, an emphasis was placed completely on calming international distress over the CFTC's assertion of extraterritorial jurisdiction on its own CFTC registered U.S. systemically risky institutions, as contemplated by Dodd-Frank.[487] The therapy adopted to lay this international "distress" to rest was the invention by the CFTC out of whole cloth of the 'substituted compliance" doctrine and its easy application to foreign swaps trades by, inter alia, the largest U.S. bank holding company swaps dealers that otherwise would lawfully be governed by Dodd-Frank.

The CFTC's entire support for its novel "substituted compliance" doctrine was the use of the legal common law rule of "international comity." Reliance on "international comity" in this context is completely misplaced. The United States Supreme Court has made clear that the use of "international comity" is merely the use of a rule of statutory construction that "reflects principles of customary international law – law that (we must assume) Congress ordinarily seeks to follow."[488] In this context, it is "the respect sovereign nations afford each other by limiting the

[486] *See* Gary Gensler, *Keynote Address on OTC Derivatives Reform,* MARKET'S OUTLOOK FOR OTC DERIVATIVES MARKETS CONFERENCE (Mar. 9, 2010), www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-32 (stating "[t]hough credit default swaps have existed for only a relatively short period of time, the debate they evoke has parallels to debates as far back as 18th Century England over insurance and the role of speculators. English insurance underwriters in the 1700s often sold insurance on ships to individuals who did not own the vessels or their cargo. The practice was said to create an incentive to buy protection and then seek to destroy the insured property. It should come as no surprise that seaworthy ships began sinking. In 1746, the English Parliament enacted the Statute of George II, which recognized that 'a mischievous kind of gaming or wagering' had caused 'great numbers of ships, with their cargoes, [to] have . . . been fraudulently lost and destroyed.' The statute established that protection for shipping risks not supported by an interest in the underlying vessel would be 'null and void to all intents and purposes.'").

[487] Bannon, s*upra* note 485.

[488] *F. Hoffmann-La Roche, Ltd. v. Empagran S.A.*, 542 U.S. 155, 164 (2004).

reach of their laws . . . exercised when *they come to interpreting the scope of laws their legislatures have enacted*."[489]

Therefore, under U.S. Supreme Court precedent, "international comity" is merely an *interpretive tool* used by U.S. judges to discern whether *ambiguous* legislative language about which country's law will be applied among countries competing to have their law applied.[490] For example, when it is *unclear* whether a U.S. statute applies extraterritorially, U.S. courts apply the doctrine of international comity to interpret the statute in question to limit its scope only to application within the U.S. unless there is a clear contrary intention through the language of the statute itself or the statute's legislative history. As shown in detail above,[491] the Dodd-Frank extraterritorial provision was written in the wake of a then-recent Supreme Court decision holding that if a statute is to have extraterritorial effect, Congress must say so clearly. And, within three days of that Supreme Court precedent, the extraterritorial provision of Dodd-Frank was inserted, which, by its plain language and contemporaneous legislative history, makes expressly clear that Congress wanted Dodd-Frank to be applied extraterritorially when swaps trading abroad could seriously hurt the U.S. economy or where the foreign trade is conducted as a ruse to evade application of Dodd-Frank.[492]

There is *no* legal precedent extant that defines "international comity" as giving authority to a U.S. administrative agency to weaken unilaterally the otherwise clear Congressional statutory language or intent that the statute must be applied extraterritorially.

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489 *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 817 (1993) (Scalia, J., dissenting) (emphasis added).

490 *Lauritzen v. Larsen*, 345 U.S. 571 (1953); U.S. v. *Aluminum Co. of Am.*, 148 F.2d 416, 443 (2d Cir. 1945) (explaining that the courts "are not to read general words . . . without regard to the limitations customarily observed by nations upon the exercise of their powers . . . .").

491 *See supra* notes 19, 330-36, 339, 344 and accompanying text.

492 *Id.*

However, the CFTC decided in the July 13 guidance that "international comity," as it improperly conceived of that doctrine, would completely trump the statute's express extraterritorial mandate with respect to how the statute would apply abroad.[493]

B. The CFTC's "Substituted Compliance" Rulings are Self-Evidently Flawed

The CFTC's wholly novel doctrine of substituted compliance – completely unmoored from the language or intent of Dodd-Frank - has been fraught with difficulties since its inception. On November 15, 2008, the G20 heads of state met in Washington, D.C. to address the then-current worldwide economic turmoil.[494] The G20 is an informal forum for advancing international economic cooperation among twenty major advanced and emerging market countries.[495]

"[A]t the November 2008 Washington DC [G20] summit, the leaders of G20 countries supported actions by [their] regulators to speed up efforts to reduce the systemic risks associated with credit default swaps and [other] over-the-counter [swaps] transactions."[496] At the follow-up Pittsburgh G20 Summit in September 2009, G20 leaders further agreed that all standardized swaps should be traded on exchanges, or electronic trading platforms; and that they should be cleared. The leaders also agreed that all swaps should be reported to regulators through trade repositories.[497] Reforms were to be completed by each of the member countries by the end of 2012.[498]

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[493] 78 Fed. Reg. 45,292 at 45,297. For a full discussion of this issue, including the inapplicability of the cases the CFTC improperly relied on to conceive of "international comity" *see generally* Michael Greenberger, *The Extraterritorial Provisions of the Dodd-Frank Act Protects U.S. Taxpayers from Worldwide Bailouts*, 80 UMKC L. REV. 965 (2012); Greenberger & Bruyere Letters *supra* note 424.

[494] Colin I. Bradford, Johannes F. Linn & Paul Martin, *Global Governance Breakthrough: The G20 Summit and the Future Agenda*, BROOKINGS (Dec. 17, 2008), https://www.brookings.edu/research/global-governance-breakthrough-the-g20-summit-and-the-future-agenda/.

[495] JAMES JACKSON & RENA S. MILLER, CONG. RESEARCH SERV., R42961, COMPARING G-20 REFORM OF THE OVER-THE-COUNTER DERIVATIVES MARKETS 2 (2013), https://fas.org/sgp/crs/misc/R42961.pdf (including a list of the twenty participating nations).

[496] *Id.* at 8.

[497] *Id.* at 9.

[498] *Id.*

At that 2009 G20 summit, a commitment was also made to bring regulators from Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland, and the United States together in November of 2012 to finalize the cross-border regulation of the swaps market.[499]

After that November 2012 G20 meeting, however, regulators from these countries concluded that, "complete harmonization – perfect alignment of rules across jurisdictions – would be impossible as it would need to overcome jurisdictions' differences in law, policy, markets and implementation timing, as well as to take into account the unique nature of jurisdictions' legislative and regulatory processes," and that, "regulatory gaps may present risks to financial markets and provide the potential for regulatory arbitrage."[500] In and of itself, this conclusion of a lack of compatibility makes clear that there can be little "comparability" among the swaps regimes of the different member countries that would justify "substituted compliance."

Moreover, by the end of 2012, only the United States, through the July 21, 2010 passage of Dodd-Frank, and Japan had enacted legislation meeting the G20 swaps reform recommendations.[501] Most other G20 countries, including the EU, were "markedly behind."[502]

Also, after the November G20 2012 meeting, the CFTC Division of Swap Dealer and Intermediary Oversight ("DSIO") issued an advisory that certain important Dodd-Frank swaps rules would *apply* to non-U.S. CFTC-registered persons, *i.e.*, foreign institutions registered with the CFTC as SDs, if there were no corresponding foreign swaps rules within their home country.[503]

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499 Press Release, U.S. CFTC, Joint Press Statement of Leaders on Operating Principles and Areas of Exploration in the Regulation of the Cross-border OTC Derivatives Market (Dec. 4, 2012), http://www.cftc.gov/PressRoom/PressReleases/pr6439-12.

500 *Id.*

501 JAMES JACKSON & RENA S. MILLER, CONG. RESEARCH SERV., R42961, COMPARING G-20 REFORM OF THE OVER-THE-COUNTER DERIVATIVES MARKETS 11 (2013), https://fas.org/sgp/crs/misc/R42961.pdf.

502 *Id.*

503 Press Release, U.S. CFTC, Applicability of Transaction-Level Requirements to Activity in the United States (Nov. 14, 2013), http://www.cftc.gov/PressRoom/PressReleases/pr6771-13.

At that time, roughly four years after the meltdown, none of the G20 nations, except the United States through Dodd-Frank and Japan, had adopted their own complete swaps regulatory regime despite the prior 2008-2009 commitments made by the G20 in the immediate wake of the crisis. There was vociferous outrage about the CFTC's initial DSIO advisory among those G20 nations without completed swaps regimes. That outrage was repeatedly expressed through*, inter alia*, direct contacts with top U.S. financial regulators. The complaints stated that the CFTC's proposal that applied Dodd-Frank to foreign swaps dealers in countries without complete swaps regulation, and who were registered with the CFTC to conduct swaps trading, was diplomatically inappropriate.

Faced with this international outrage (wholeheartedly supported by, for example, U.S. bank holding company swaps dealers and their representatives) other U.S. financial regulators applied strong pressure on the CFTC to provide relief to the complaining G20 countries.

In response, the CFTC's DSIO staff, *inter alia*, through informal "no-action" orders, suspended these important Dodd-Frank swaps rules as applied to foreign CFTC registrants even in countries with virtually no swaps regulation; and even worse it was made expressly clear that for these purposes, a "foreign" registrant could be a CFTC registered "foreign" subsidiary of a U.S. swaps dealer whether or not "deguaranteed" by the parent. This remarkable exemption was quite controversial and therefore originally was to expire January 14, 2014, or days *after* Chairman Gensler (the strongest Obama administration supporter of the extraterritorial application of Dodd-Frank to large systemically risky U.S. swaps dealers) left the CFTC.[504] When he left at the end of December 2013, Gensler was also unaware of the "deguarantee loophole," which did not appear on the CFTC's radar until May 2014; or of the assigning of swaps contracts

[504] CFTC Staff Letter no. 13-71, No-Action Relief: Certain Transaction-Level Requirements for Non-U.S. Swap Dealers (Nov. 26, 2013), http://www.cftc.gov/LawRegulation/CFTCStaffLetters/13-71; Nihal S. Patel, *United States: CFTC Extends No-Action Relief For Non-U.S. Swap Dealers*, MONDAQ (Aug. 11, 2017), http://www.mondaq.com/unitedstates/x/618862/Commodities+Derivatives+Stock+Exchanges/CFTC+Extends+NoAction+Relief+For+NonUS+Swap+Dealers ("The relief provided by the Divisions applies to swap dealers ('SDs') who are non-U.S. persons and enter into transactions with other non-U.S. persons (other than 'guaranteed affiliates' or 'conduit affiliates') using personnel or agents in the United States to 'arrange, negotiate, or execute' the transactions (referred to in the letter as 'Covered Transactions'). In accordance with previous letters (CFTC Staff Letter Nos. 13-71, 14-01, 14-74, 14-140 and 15-48), the Divisions stated that they will not recommend enforcement action against non-U.S. SDs (whether or not the SDs are affiliated with U.S. persons) for failure to comply with the following requirements in connection with Covered Transactions:- transaction-level requirements for Covered Transactions other than those made with other non-U.S. SDs; and -transaction-level requirements (other than those in Regulations 23.503 ('Portfolio compression') and 23.504 ('Swap trading relationship documentation')) for Covered Transactions with other non-U.S. SDs.").

to newly deguaranteed subsidiaries that were otherwise wholly arranged, negotiated, and executed in the U.S. by U.S. bank personnel.[505]

However, because the G20 countries continued to move slowly in creating their own swaps regulatory regimes, and because of the ferocity of the G20 and U.S. bank swaps deals' lobbying against the CFTC's adherence to Dodd-Frank, the original preemption date of January 14, 2014, was extended on a "time limited" basis, by the CFTC staff *five* times: to September 15, 2014;[506] December 31, 2014;[507] September 30, 2015;[508] September 30, 2016;[509] and September 30, 2017.[510] On July 25, 2017,[511] CFTC staff for *a sixth time* exempted foreign swaps dealers, including "foreign subsidiaries" of, *inter alia*, U.S. bank holding company swaps registered to trade swaps by the CFTC from certain important CFTC swaps rules. Unlike the five previous "time limited" exemptions, however, the July 25, 2017 exemption *did not specify an end date*, stating only and confusingly that: "the Divisions believe that an extension . . . is warranted until the effective date of any Commission action addressing whether a particular Transaction-Level Requirement is or is not applicable to a Covered Transaction."[512]

Under this CFTC staff no action regime, foreign swaps dealers registered, including foreign subsidiaries (whether guaranteed or not) of the four big U.S. bank holding company swaps dealers, need not comply with key Dodd-Frank swaps regulations when trading with "non-U.S.

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505 *See supra* notes 436-45, and accompanying text. Nor did Gensler know before he left the CFTC in December 2013 that the original January 2014 deadline for foreign swaps traders registered by the CFTC as, *inter alia*, swaps dealers to comply with Dodd-Frank's swaps rules would be extended by CFTC staff six times with the final January 25, 2017 extension having no deadline for compliance in any way. *See infra* notes 507-12.

506 CFTC Staff Letter no. 14-01, Extension of No-Action Relief: Transaction-Level Requirements for Non-Swap Dealers (Jan. 3, 2014), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/14-01.pdf.

507 CFTC Staff Letter no. 14-74, Extension of No-Action Relief: Transaction-Level Requirements for Non-Swap Dealers (June 4, 2014), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/14-74.pdf.

508 CFTC Staff Letter no. 14-140, Extension of No-Action Relief: Transaction-Level Requirements for Non-Swap Dealers (Nov. 14, 2014), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/14-140.pdf.

509 CFTC Staff Letter no. 15-48, Extension of No-Action Relief: Transaction-Level Requirements for Non-Swap Dealers (Aug. 13, 2015), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/15-48.pdf.

510 CFTC Staff Letter no. 16-64, Extension of No-Action Relief: Transaction-Level Requirements for Non-Swap Dealers (Aug. 4, 2016), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/16-64.pdf.

511 CFTC Staff Letter no. 17-36, Extension of No-Action Relief: Transaction-Level Requirements for Non-Swap Dealers (July 25, 2017), https://www.cftc.gov/sites/default/files/idc/groups/public/@lrlettergeneral/documents/letter/17-36.pdf.

512 *Id.*

persons," including the deguaranteed "foreign" subsidiaries of U.S. persons. This is so, even if the "foreign" swaps dealers' home country has *no* or *inadequate* applicable swaps regulation to take the place of the ignored and otherwise applicable CFTC swaps rules. This then is yet another unending CFTC *staff-directed* exemption from key Dodd-Frank swaps regulation requirements.

C. "Substituted Compliance" Threatens Global Financial Stability and U.S. Taxpayers

1. Japan

On January 6, 2016, the CFTC made favorable "substituted compliance" comparability determinations for Japan's margin requirements for uncleared swaps. However, CFTC Commissioner Bowen issued a withering and highly analytical dissent to this CFTC substituted compliance approval by the other two voting CFTC commissioners. Commissioner Bowen showed the extreme divergence of Japanese swaps rules from those of the CFTC regarding the Japanese: (1) lax requirements to keep customer margin safe from default[513]; (2) allowance of trading with counterparties in bankruptcy-risky venues[514]; and (3) the volatility and instability of the collateral allowed by the Japanese – but not the U.S.- to be eligible as margin.[515]

Commissioner Bowen noted that these significant areas of divergence between Japanese and the United States' margin rules would likely substantially compound difficulties for

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[513] Sharen Y. Bowen, Comm'r, CFTC, Dissenting Statement Regarding Comparability Determination for Japan: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants (Sept. 8, 2016), http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement090816b. The Commissioner stated, "[o]ur rules require customer collateral to be held by a third party – not by either one of the counterparties. This is a safeguard for bankruptcy. If the money is held by one of the counterparties, then a bankruptcy court may use that money to meet the counterparty's debts." *Id.*

[514] *See id.* ("There are certain developing countries where there is little certainty that collateral will be there if there is a bankruptcy (non-netting jurisdictions), and/or where they do not adequately protect customer funds from that of the dealer ('non-segregation jurisdictions'). Under our rules, our US dealers have to limit the way they trade with counterparties in these bankruptcy-vulnerable jurisdictions because we are not confident that our American investors will get their money back in a bankruptcy scenario.").

[515] *See id.* ("There are significant differences in the treatment of collateral between our margin rule and the Japanese rule. First, while our rules limit daily variation margin to cash for dealer-to-dealer swaps, under Japanese law, variation margin could be in a number of much less liquid instruments. And second, while we require a 25% haircut for certain equities not included in the S&P 500, under Japanese law, equities included in major equity indices of certain designated countries just have a 15% blanket haircut.").

swaps customers in bankruptcy proceedings of failed Japanese swaps dealers where the collateral, unlike that required by the United States, was so unreliable that it would likely disappear by the time of bankruptcy. Bowen illustrated this concern by showing that

> "though these [Japanese-regulated] companies are physically located in Japan; their cash line runs right back to the United States. That risk could be borne again [upon Japanese defaults or threatened defaults] by American households. *A comparability determination should not be the back-door way of undoing or weakening our regulations and thereby incentivizing our companies to send their risky business to their affiliates located in Japan*."[516]

2. The European Union

The EU has similarly been granted favorable CFTC "substituted compliance" determinations in replacing the CFTC's rule requiring margin for uncleared swaps with a much weaker EU margin rule.[517] However, there have been strong intimations that the EU extracted these favorable rulings from the CFTC by threatening a swaps "trade war" with the U.S. by raising the prospect of the application of extremely harsh EU rules to U.S. persons seeking to trade swaps within EU countries. For example, EU "proposals would [have] force[d] US investment banks such as Goldman Sachs and JPMorgan to have additional capital and liquidity in the EU so their subsidiaries [in the EU supposedly] can better withstand a crisis and be separately wound up if needed by European authorities."[518]

In this regard, the Bank of England concluded that

> "[u]nder EU proposals, non-EU banks with significant activities in Europe would be forced to group their operation under 'intermediate holding companies' . . . The[se] plans have largely been viewed as retaliation against the US, . . . [These EU] commission proposals 'may not be aligned with US rules on the separation' of banks and broker dealers, . . . and are not in line with international standards.

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[516] *Id.* (Emphasis added).

[517] *See* Comparability Determination for European Union: Certain Entity-Level Requirements, 78 Fed. Reg. 78,923, 78,927-36 (Dec. 27, 2013).

[518] Alex Barker and Jim Brunsden and Martin Arnold, *EU to Retaliate Against US Bank Capital Rules*, FIN. TIMES (Nov. 21, 2016), https://www.ft.com/content/26078750-b003-11e6-a37c-f4a01f1b0fa1.

> [The British have] told [EU] counterparts that . . . [it] believes the [EU] measures are protectionist and anti-competitive."[519]

Elsewhere certain EU swaps rules, applied only to non-EU banks doing business in the EU, have been described as an "attempt to build 'walls' around the EU. [T]his would be an extreme version of extraterritorial effect of legislation, one that would not go down well in other capitals . . . . We have no trouble imagining that if the authorities in Washington were writing in such terms, Brussels would be up in arms."[520]

The CFTC's favorable EU "substituted compliance" comparability determination was therefore widely recognized as an "olive branch to Europe," to end an EU inspired swaps trade war.[521] In this regard, the CFTC's favorable EU substituted compliance determination was a matter of rote, rather than guided by reality, in that the U.S. agency merely compared swaps regulatory *language* of the EU to the U.S. rather than compare the regulatory *effect* of the EU language. Just as one could not logically compare free speech rights within the old Soviet Union to those of the United Sates by merely reading those two countries' constitutional free speech language, by ignoring the complex and lax *application* of the EU's swaps regime, the CFTC managed to mask a true comparability of the EU's swaps regulation to that of the United States.

For example, upon examination of the *effect* of EU financial directives in the "real world," it is clear that there can be no viable comparability of the EU regulatory approach with that of Dodd-Frank. It has been widely recognized that "[t]here is no common regulatory philosophy between [EU] Member States, let alone a common legal system."[522] This starting premise of the EU swaps regulation certainly does not bode well for a "comparability" finding with the U.S. when there is so little comparability among EU members. Indeed, the "[n]ew European Union rules [, supposedly] designed to bring stability and clarity to opaque derivatives markets [,]

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519 Caroline Binham & Jim Brunsden, *Bank of England Attacks Brussels Bank Capital Reforms*, FIN. TIMES (Jan. 27, 2017), https://www.ft.com/content/600df898-e4ac-11e6-9645-c9357a75844a.

520 *Id*.

521 *CFTC Offers Olive Branch to Europe*, THE BANKER (Mar. 11, 2014), http://www.cftc.gov/PressRoom/SpeechesTestimony/bowenstatement090816b.

522 Georges Ugeux, *Can Europe Produce a Coherent and Effective Financial Regulation?*, 18 COLUM. J. EUR. L. 20, 4 (2012).

are sowing confusion . . . raising more questions than answers."[523] The EU has "a rule book without totally defined rules . . . . Is it going to protect anybody? No. Will it stop rogue traders? No. So what is it for?"[524]

The EU rules are otherwise described as a "quagmire of uncertainties."[525] For example, because "Europe does not require [the] use [of] a regulated exchange to ensure transparency and the clearing of derivative transactions . . . [i]t is an area where the risk of regulatory arbitrage is real and could lead to market distortions."[526]

Because of the laxity in EU financial regulatory rules, the EU banking system has shown the substantial cracks under the EU financial regulatory paradigm. For example, in 2016, Italian banks reported a total of €360 billion in outstanding loans, the majority of which were non-performing.[527] As a widespread practice, Italian banks regularly "loaned money to hundreds of small companies that had no business taking on debt."[528] Consequently, it is likely that the overwhelming majority of these loans will remain unpaid.

Eight of Italy's major banks, including Banca Monte dei Paschi di Siena, the oldest surviving and operating bank in the world, are at present in financial crisis.[529] According to KPMG, the position of Banca Monte dei Paschi di Siena is "extremely weak as it was the worst performer in

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523 Alexander Winning, *EU Derivatives Rules Sow Confusion in Metals Markets*, REUTERS (Feb. 26, 2014), http://www.reuters.com/article/lme-derivatives-idUSL6N0LT1IL20140226.

524 *Id.*

525 *Id.*; *see also* James Politi, *Italian Central Bank Chief Blames Recession and EU rules for Bank Collapses*, Financial Times (Online) (Dec. 19, 2017), https://www.ft.com/content/601d5637-f181-38ed-b8ff-5efcb8d087c0.

526 Ugeux, *supra* note 518.

527 Kenneth Rapoza, *Are Investors Betting on an Italian Banking Crisis?*, FORBES (Mar. 9, 2017), https://www.forbes.com/sites/kenrapoza/2017/03/09/are-investors-betting-on-an-italian-banking-crisis/#2d0501326916. A non-performing loan is defined as "a loan on which the borrower is not making interest payments or repaying any principal. *Definition of Non-Performing Loan NPL*, FIN. TIMES, http://lexicon.ft.com/Term?term=non_performing-loan--NPL (last visited Mar. 29, 2017).

528 Jim Edwards, *Italy's Banks Might Need a €52 Billion Bailout*, BUS. INSIDER (Nov. 29, 2016), http://www.businessinsider.com/statistics-non-performing-loans-npls-italy-banking-system-2016-11; *see also* Rachel Sanderson, *Once-Thriving Veneto Becomes Heart of Italy's Bank Crisis*, FIN. TIMES (NOV. 24, 2016), https://www.ft.com/content/04869eca-b15e-11e6-9c37-5787335499a0 ("The banks' close relationships with customers led to cozy banking practices, such as the award of *azioni baciate*, or kissing shares, which backfired as business failures mounted and the money ran out.").

529 Sonia Sirletti & Chiara Vasarri, *Italy Approves $21 Billion Fund to Shore Up Its Troubled Banks*, BLOOMBERG (Feb. 16, 2017), https://www.bloomberg.com/news/articles/2017-02-16/italy-approves-21-billion-fund-to-shore-up-its-troubled-banks.

the annual stress tests carried out on fifty-one lenders across the EU in late 2016. The bank had nearly €50 billion in non-performing loans, accounting for 38% of its total loans."[530] In July of 2017, the bank announced a new restructuring plan — a plan that saw the Italian government take control of roughly 70 percent of the bank and the closure of a further 600 branches, making a total of 1,400 branch closings and 5,500 job cuts.[531] The dissatisfaction of Italians with that country's deteriorating financial infrastructure were laid bare in the March 4, 2018 Italian election, resulting in substantial gains for the anti-establishment party, the Five Star Movement, and a hung parliament.[532] Currently, almost a third of young Italians are jobless, about 30 percent of the total population is deemed "at risk of poverty," and the recent election is only likely to cast more doubt on the struggling Italian economy.[533]

Italy is far from an isolated example of European bank distress. Bank failures also threaten the financial security of both Spain and Portugal.[534] Since 2008, Germany's

> "Deutsche Bank has faced numerous lawsuits and investigations over its alleged role in rigging of interest-rate benchmarks and commodity prices, violations of US sanctions and mis-selling mortgage backed securities. Even after paying over $16 [billion] in fines and settlements worldwide . . . for serious misconduct, the troubles of [that bank] are not yet over[,] as it has lost more than half of its value in 2016."[535]

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530 *See* WEED, *supra* note 343.

531 Rachel Sanderson, *EU Approval of Monte Paschi Restructure Paves Way for State Control*, FIN. TIMES (July 5, 2017), https://www.ft.com/content/9a0a1d68-615e-11e7-91a7-502f7ee26895.

532 Larry Elliot, *A Perfect Economic Storm Made Italy Ripe for a Protest Vote*, THE GUARDIAN (Mar. 5, 2018), https://www.theguardian.com/world/2018/mar/05/italy-election-perfect-economic-storm-ripe-for-a-protest-vote (explaining that the stagnant Italian party facilitated substantial gains for anti-establishment political parties).

533 Giovanni Legorano & Deborah Ball, *Surge by Populists Leaves Italy Without Clear Victor*, WALL ST. J. (Mar. 4, 2018), https://www.wsj.com/articles/italys-elections-appear-to-have-yielded-a-hung-parliament-exit-polls-1520201994.

534 *See* Sarah Gordon, *Bankia A Symbol of Europe's New Banking Wobble*, FIN. TIMES (Feb. 24, 2016), https://www.ft.com/content/1078df3a-da55-11e5-a72f-1e7744c66818 (discussing how the near collapse of *Bankia*, one of Spain's largest banking institutions, cost the country and its taxpayers billions in "a series of bailouts."); *see also* Elena Holodny, *Italy Isn't the Only European Country with 'a Systemic Banking Crisis'*, BUS. INSIDER (July 12, 2016), http://www.businessinsider.com/portugal-banking-crisis-2016-7 ("Regarding Portugal's financial system, its banks are loaded with bad debts and are starved for capital . . . . Portugal's largest deposit taker, Caixa Geral de Depositors, needs a cash injection of 5 billion euros ($5.53 billion), while its largest private bank, BCP, is facing similar issues and may need an estimated 2.5 billion euros ($2.76 billion) . . . .").

535 WEED, *supra* note 343, at 13.

Accordingly, Deutsche Bank, the largest continental European bank in deposits, is widely recognized to be teetering towards collapse. Under the "watchful" eye of the EU financial regulators, "Deutsche Bank failed the U.S. Fed's stress test . . . ," and it is "sitting on a mountain of derivatives, estimated to be as high as $75 trillion."[536] During the first quarter of 2018, James von Moltke, Deutsche Bank's chief financial officer, announced that the Deutsche Bank's investment banking division would lose €450m in revenue due to "the strong euro and higher refinancing costs . . . ."[537]

In this regard, "[i]n June 2016, the IMF in its report on Financial System Stability Assessment on Germany stated that 'among the G-SIBs (globally systemically important banks), Deutsche Bank appears to be the most important net contributor to systemic risks, followed by the [United Kingdom's] HSBC and [Switzerland's] Credit Suisse.'"[538] It has been estimated that a "failure of Deutsche Bank may trigger a far bigger financial crisis than the 2008 crisis. As Deutsche Bank is highly interconnected with other big banks and insurance companies in Germany, there is a valid concern that it could pose a systemic threat to Germany's entire financial sector."[539]

If performance like this is allowed in Germany, for example, it defies the imagination how any EU-driven swaps regulatory regime could serve as a proper 'substitute' for Dodd-Frank as applied to the four large U.S. bank holding company swaps dealers subsidiaries in Europe, especially when U.S. – not EU – taxpayers are understood to be those U.S. banks' lender of last

[536] Daryl Montgomery, *Coming Soon from Europe: The Next Global Financial Crisis*, SEEKING ALPHA (July 7, 2016), https://seekingalpha.com/article/3987017-coming-soon-europe-next-global-financial-crisis.

[537] Olaf Storbeck, *Deutsche Bank Slides After Warning on €450 Q1 Headwind*, FIN. TIMES (Mar. 21, 2018), https://www.ft.com/content/4a8e0bba-2d13-11e8-a34a-7e7563b0b0f4. See also, William Canny, "*Deutsche Bank Flub Said to Send $35 Billion Out the Door" http://www.standard.net/Business/2018/04/19/Deutsche-Bank-flub-said-to-send-35-billion-briefly-out-the-door* (Bloomberg, April 18, 2018) ("A routine payment went awry at Deutsche Bank last month when Germany's biggest lender inadvertently sent 38 billion euros ($35 billion) to an exchange as part of its daily dealings in derivatives, according to a person familiar with the matter."); see also Richard Milne, *Latvia banking scandal leaves Europe's regulators red-faced*, Inside Business (Apr. 4, 2018).

[538] WEED, *supra* note 343, at 13.

[539] *Id.*

resort – as they were in 2008. As of this writing, Deutsche Bank is being deemed near collapse[540], and the EU and even its member countries, including Germany, are readying an assortment of bailout plans to rescue troubled EU banks threatened with failures.[541]

3. The United Kingdom

If the problems that are rippling through the continental European banks do not sufficiently raise the level of concern about deferring to EU financial regulatory law to regulate the swaps of, *inter alia*, of the foreign subsidiaries of the four biggest U.S. bank holding company swaps dealers, then the prospect of applying the United Kingdom's financial regulation, especially when the U.K. goes outside of the EU under "Brexit," should certainly tip the scales. London's financial services center, the so-called "City," has been the home to many of the most troubling financial regulatory calamities immediately before, during, and after the financial 2008 meltdown.

a. Northern Rock

The massive 2007 failure at Britain's Northern Rock bank demonstrates the nexus between the U.K's once highly lauded "light touch regulation" and the increased risk of systemically significant big bank failures. Relying on a business model which prioritized "short-term funding from the wholesale market to make long-term mortgage loans,"[542] Northern Rock was forced to ask the Bank of England for what was then an unprecedented, emergency bail out in 2007. The very-public €25 billion loan resulted in massive queuing outside of Northern Rock branches, as customers lined up to withdraw billions of pounds.[543] The "lines of Northern Rock

540 On June 1, 2018, the *Financial Times* reported: "The cost of insuring [Deutsche Bank] against a debt default soared to almost five times that for Lloyds. . . .Two events rattled confidence. It emerged that [a] US [prudential regulators] had designated a US subsidiary of Deutsche as 'troubled.' And Standard & Poor's downgraded Duetsche's credit rating."; *Deutsche Bank: taking one for the team*, Financial Times (Online) (Jun. 1, 2018), https://www.ft.com/content/9e980756-65b2-11e8-a39d-4df188287fff.

541 *See E.g.*, Francesco Guarascio, *In Anti-Austerity Move, EU Eyes Measures Against Jobless Surges*, The New York Times (May 31, 2018), https://www.nytimes.com/reuters/2018/05/31/world/europe/31reuters-eurozone-budget-commission.html; *Deutsche Bank: taking one for the team*, Financial Times (Online) (Jun. 1, 2018) ("[I]ncompetence in banking may be a deliberate strategy to make [Germany look] more relatable to other Europeans. Even bungling British banks and scatty Italian lenders can feel superior to Deutsche Bank. But there are limits. *Germany will not let this battered national champion go bust*." (Emphasis added.).

542 Brooke Masters, *Northern Rock Exposed Regulatory Failings*, FIN. TIMES (Sept. 12, 2012), https://www.ft.com/content/7bb1ab1a-fc00-11e1-af33-00144feabdc0.

543 Alan G. Hallsworth & Frank Skinner, *Visibly in Trouble: Northern Rock, a Post-Morten on a Financial Crisis*, 40 ROYAL GEOGRAPHICAL SOC'Y 278 (2008).

depositors" "through many main streets across the U.K. provided a vivid demonstration of [a financial] regulatory crisis."[544] And, the regulatory response to that failure has been described as a "serious test of the workability of the regulatory model exemplified by" Northern Rock's then-U.K. financial regulator.[545] One leading financial academic noted that, "in spite of the promise [by British financial regulators] of cohesive, clear, and consolidated [financial market] oversight, the conduct of [those regulators] in preventing the Northern Rock debacle, and in re-acting to it subsequently, fell substantially short of expectations."[546]

The U.K.'s own HM Treasury Select Committee, in its report on the failure of Northern Rock, noted that Britain's inadequate financial regulatory structure, had contributed to the state of affairs that culminated in the U.K.'s first bank run since the Victorian era.[547] The then-prime British regulator, the Financial Services Authority ("FSA"), identified numerous serious failures in its oversight in its report on its handling of the Northern Rock crisis. [548]

Throughout the Northern Rock crisis, a major criticism leveled at British financial regulation was of the lack of readiness displayed in acknowledging and reacting to the extent and depth of Northern Rock's troubles.[549] The dysfunction among British regulators during that crisis belied a fundamental incompatibility in the regulatory priorities of the U.K. financial regulatory institutions, rather than "demonstrating the coordination that had been promised and practiced in trial runs conducted by [those regulators] for just such a crisis."[550]

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544 Yesha Yadav, *Looking for the Silver Lining, Regulatory Reform After the Credit Crunch*, 15 STAN. J.L. BUS. & FIN. 314, 334 (2010).

545 Carlos Conceicao, *Rocking the Boat*, THE LAWYER, May 12, 2008.

546 Yadav, *supra* note 545, *citing* FINANCIAL SERVICES AUTHORITY, EXECUTIVE SUMMARY OF THE INTERNAL AUDIT REPORT (Mar. 26, 2008), http://www.fsa.gov.uk/pubs/other/exec_ summary.pdf.

547 HOUSE OF COMMONS TREASURY COMMITTEE, FIFTH REPORT OF SESSION 2007-08: THE RUN ON THE ROCK 13 (Jan. 24, 2008).

548 *Id*.

549 *Id.* ("The failure of Northern rock, while a failure of its own Board, was also a failure of its regulator . . . . [T]he Financial Services Authority exercises a judgment as to which 'concerns' about financial institutions should be regarded as systemic and thus require action by the regulator. In the case of Northern Rock, the FSA appears to have systematically failed in its duty as a regulator to ensure Northern Rock would not pose such a systemic risk . . . .").

550 Yadav, *supra* note 545.

Generously described, the U.K "[h]as a fragmented regulatory system, consisting of regulators that are keen to pass on their responsibilities to others. Overlapping U.K. financial regulatory structures squander time and resources, making it difficult for regulation to be both effective and timely."[551]

b. HSBC's Money Laundering

Britain's HSBC laundered nearly $1 billion of drug and terror money on behalf of the Mexican Sinaloa and Colombian Norte del Valle drug cartels, and it violated international sanctions by offering banking services to Iran, Cuba, Burma, Libya, and Sudan.[552] Despite this unprecedented illegal behavior, U.K. regulators did not prosecute, or otherwise sanction HSBC or its officers and employees involved in this widespread misconduct. Rather, British financial regulators and HSBC together exerted their influence within the British Government, to put unrelenting pressure on the U.S. Department of Justice ("DOJ") to: (1) not prosecute HSBC in the United States under U.S. criminal law: and (2) otherwise lobby hard and successfully for the lowering of the substantial proposed civil penalties to be assessed by DOJ on HSBC.[553] The British lobbying of the DOJ consisted mainly of "warn[ings] that prosecuting a 'systemically important financial institution' like HSBC 'could lead to [financial] contagion' and pose 'very serious implications for financial and economic stability, particularly in Europe and Asia.'"[554] It was also contended: "If HSBC had been found guilty of the potential charges, the US government would have been required to review and possibly revoke HSBC's charter to do business in the

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551 *'Captured Regulators, Impunity Behind HSBCs Decision to Keep HQ in London' – Experts*, REUTERS (Feb. 17, 2016), https://www.rt.com/uk/332791-hsbc-city-hq-remain.

552 Rupert Neate, *HSBC Escaped US Money-Laundering Charges after Osborne's Intervention*, GUARDIAN (July 11, 2016), https://www.theguardian.com/business/2016/jul/11/hsbc-us-money-laundering-george-osborne-report.

553 *Id.*; *'Captured Regulators, Impunity behind HSBCs Decision to Keep HQ in London' – Experts*, REUTERS (Feb. 17, 2016), https://www.rt.com/uk/332791-hsbc-city-hq-remain.

554 Neate, *supra* note 552 (second alteration in the original).

US. The [British government] repeatedly warned that even the *threat* of possible charter withdrawal could have caused a fresh global financial crisis."[555] In the end, the DOJ did not prosecute HSBC; it lowered substantially the civil fines it assessed; and it did not trigger a review of HSBC's right to conduct business in the U.S.

That the "light touch" financial regulatory handling of HSBC by the U.K. government had no long-lasting remedial effect is made clear by recent investigative journalistic reports that HSBC has also laundered $740 million in Russian organized crime funds; whereas, RBS, majority-owned by the U.K. government, handled $113 million in Russian laundered money from a network dubbed the "Global Laundromat."[556]

Breaking that story, the *Guardian* stated that financial records showed that Russians moved "at least $20 billion" out of the country between 2010 and 2014, and that a portion of that amount "ended up at overseas banks."[557] In addition to HSBC, the records implicated a number of other prominent banks, including RBS, which allegedly handled $113 million of Global Laundromat cash.[558] Other cited banks were Standard Chartered Plc, UBS Group AG, Citigroup Inc., Bank of America Corp., Barclays Plc, and ING Group NV, which are said to have processed between $2 million and $37 million.[559] In response to these allegations, HSBC replied:

> "HSBC is strongly committed to fighting financial crime. The bank has systems and processes in place to identify suspicious activity and report it to the appropriate government authorities . . . ."[560]

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[555] *Id.* (emphasis added).

[556] Zeke Faux & Yalman Onaran, *Laundered Russian Cash went through Big Banks, Guardia Says*, BLOOMBERG (Mar. 20, 2017), https://www.bloomberg.com/news/articles/2017-03-20/laundered-russian-cash-flowed-through-major-banks-guardian-says.

[557] *Id.*

[558] *Id.*

[559] *Id.*

[560] *Russian Money and the 'Global Laundromat': What Banks Said*, GUARDIAN (Mar. 20, 2017), https://www.theguardian.com/world/2017/mar/20/russian-money-and-the-global-laundromat-what-uk-banks-said.

c. The Libor Fixing Scandal

At the center of the now notorious Libor London interest rate fixing scandal were the U.K.'s Barclays Bank and Barclays Capital, which, *inter alia*, were found to have manipulated and made false reports concerning the published Libor benchmark for interest rate swaps index.[561] One former *Wall Street Journal* (now *New York Times*) editor and author has recently explained in a thorough analysis of this Libor bank manipulation:

> "[Libor is] often known as the world's most important number. Financial instruments all over the globe—a volume so awesome, well into the tens of trillions of dollars, that it is hard to accurately quantify—hinge on tiny movements in Libor. In the United States, the interest rates on the most variable-rate mortgages are based on Libor. So are many auto loans, student loans, credit card loans . . . almost anything that doesn't have a fixed interest rate. The amounts that big companies pay on multibillion-dollar loans are determined by Libor . . . . Pension funds, university endowments, cities and towns, small businesses and giant companies all use them to speculate on or protect themselves against swings in interest rates. So if something was wrong with Libor, the pool of potential victims would be vast. As it turned out, *something* wasn't wrong with Libor, *everything* was."[562]

One thing is certain: those harms from manipulating Libor far exceeded the fines and penalties that were extracted during settlement of the misconduct.[563] In May 2015, the Department of Justice announced that four major banks — Citicorp, JPMorgan Chase, Barclays PLC, and RBS — pled guilty to felony charges for "conspiring to manipulate the price of U.S. dollars and euros exchanged in the foreign currency exchange (FX) spot market."[564] In all, the criminal

561 Press Release, CFTC, CFTC Orders Barclays to Pay $200 Million Penalty for Attempted Manipulation of and False Reporting Concerning LIBOR and Euribor Benchmark Interest Rates (June 27, 2012), http://www.cftc.gov/PressRoom/PressReleases/pr6289-12.

562 *See* ENRICH, *supra* note 90, at 5.

563 *Id.*; *see also* Press Release, Dep't of Justice, *Five Major Banks Agree to Parent-Level Guilty Pleas* (May 20, 2015), https://www.justice.gov/opa/pr/five-major-banks-agree-parent-level-guilty-pleas (The criminal fines owed by each bank is as follows: Citicorp--$925 million, Barclays--$650 million, JPMorgan--$550 million, and RBS--$395 million).

564 DOJ Press Release, *supra* note 562.

fines totaled over $2.5 billion, which was to be paid to the Department of Justice and U.S. regulators.[565] Pleading guilty to one separate felony count of wire fraud in connection to its manipulation of Libor, UBS was fined $203 million.[566] Attempts**,** however**,** by U.K. and U.S. prosecutors to gain criminal convictions after a trial have generally proven quite elusive.[567]

Establishing Libor in 1986, the British Banker's Association ("BBA") oversaw the calculation of Libor rates for nearly three decades.[568] In September 2012, the British Government commissioned a report to review Libor.[569] Referred to as the Wheatley Review, the main recommendation issued by the report was that administration of Libor be transferred to a new administrator: "The BBA should transfer responsibility to a new administrator, who will be responsible for compiling and distributing the rate, as well as providing credible internal governance and oversight. This should be achieved through a tender process to be run by an independent committee convened by the regulatory authorities."[570] In 2014, the Hogg Tendering Advisory Committee replaced the BBA with the Intercontinental Exchange Group (ICE), which has since worked to impose greater transparency and oversight.[571]

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565 *Id.*

566 *Id.*

567 Chris Dolmetsch, *Libor-Rigging Judge's Musings Raise Doubt About U.S. Prosecution*, BLOOMBERG MARKETS (Mar. 29, 2018), https://www.bloomberg.com/news/articles/2018-03-29/libor-rigging-judge-s-musings-raise-doubt-about-u-s-prosecution ("A judge voiced skepticism of a U.S. case against two former Deutsche Bank AG traders charged with rigging the Libor interest-rate benchmark, questioning whether the government will be able to present sufficient evidence to convict the pair."); Chad Bray, *Two Former Barclays Traders Acquitted in Libor Retrial*, N.Y. TIMES (Apr. 6, 2017), https://www.nytimes.com/2017/04/06/business/dealbook/stylianos-contogoulas-ryan-reich-barclays-acquitted-libor.html (detailing how attempts to convict individual traders on criminal charges for manipulation of interest-rate benchmarks in both the U.K and U.S. have been difficult as six former brokers from financial firms and two former Barclays traders have been acquitted of conspiracy to defraud charges in the U.K); *see also* Chad Bray, *Convictions of 2 Former Traders in Libor Scandal Are Dismissed*, N.Y. TIMES (July 19, 2017), https://www.nytimes.com/2017/07/19/business/dealbook/convictions-of-2-former-traders-in-libor-scandal-are-dismissed.html (noting that in 2017, the United States Court of Appeals for the Second Circuit dismissed conspiracy and fraud charges against two former traders in "what had been the first American criminal case to arise from investigations into" the Libor scandal); *but see* Barney Thompson, *Jailed Libor Trader Hayes Loses Appeal Over Family House Sale*, FIN. TIMES (Mar. 28, 2018), https://www.ft.com/content/b27b5226-32a1-11e8-ac48-10c6fdc22f03 ("Tom Hayes, the former UBS and Citigroup trader who was jailed for conspiring to rig the Libor benchmark interest rate, has lost his appeal against a confiscation order that forced his wife to sell their family home.").

568 John Kiff, *What is Libor?*, INT'L MONETARY FUND (Dec. 2012), http://www.imf.org/external/pubs/ft/fandd/2012/12/basics.htm.

569 Prableen Bajpai, *Why BBA Libor Was Replaced by ICE Libor*, INVESTOPEDIA (Mar. 31, 2015), http://www.investopedia.com/articles/investing/033115/why-bba-libor-was-replaced-ice-libor.asp.

570 *Id.*

571 *Id.*

d. Brexit

The U.K's departure from the EU creates a further shroud of uncertainty over what form swaps regulations may take in the U.K. once it is freed of any EU constraints.[572]

Alarm bells have been ringing over Britain's future loss of the EU "passport" rule, under which London banks would no longer automatically have license to do business throughout the EU.[573] However, that potential lost business is likely to pale in comparison to the increased regulatory "race to the bottom" the U.K. will likely exhibit when it no longer needs to follow what certain U.K. bankers have referred to as the "idiot rules that the EU has tried to place upon The City [London]."[574]

The animosity expressed by U.K. banking institutions toward EU financial regulation is likely to inspire a dramatic undoing of the EU financial regulatory structure as it was applied to the U.K. Indeed, so worried has been the EU over the U.K.'s likely Brexit response to being freed of EU financial regulation, that it has already warned the U.K. that the latter's likely relaxed resulting financial regulations will not be granted "equivalency" by the EU "if the [U.K.] conducts a regulatory bonfire or retreats to a light-touch supervision."[575] And, the head of the Bank of England's Prudential Regulation Authority warned against a "retreat" by the U.K. to "'light touch' regulation after Brexit . . . ."[576]

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572 Outstanding derivative contracts between parties in the EU and U.K. are valued at €26tn. Caroline Binham, *BoE Warns of 'Material Risks' from Brexit*, FIN. TIMES (Mar. 16, 2018), https://www.ft.com/content/4c79e2f2-28fc-11e8-b27e-cc62a39d57a0.

573 Tim Worstall, *Brexit Effects: A Deregulated City Will Thrive Outside the European Union*, FORBES (June 27, 2016), http://www.forbes.com/sites/timworstall/2016/06/27/brexit-effects-a-deregulated-city-will-thrive-outside-the-european-union/#49ae5ef13998. Firms will be able to use the passporting arrangement through the transitional period, scheduled to end December 2020. *See* Caroline Binham, *Regulators Step Up Efforts to Safeguard City of London's Status*, FIN. TIMES (Mar. 28, 2018), https://www.ft.com/content/2fbb0c8c-3288-11e8-ac48-10c6fdc22f03.

574 *Id*; *see also* Laura Noonan, Caroline Binham & Chris Giles, *Treasury Promises Further Work on Standards after Claims BoE Pressure Libor*, FIN. TIMES (Apr. 10, 2017), https://www.ft.com/content/d9732af1-f3c0-3e5a-8c54-a88483bf4b4b.

575 Jim Brunsden & Lindsay Fortado, *Brussels Sets Out Tough New Line on Equivalence*, Fin. Times (Feb. 26, 2017), https://www.ft.com/content/f9f3ffc2-fc1a-11e6-96f8-3700c5664d30.

576 Barney Jopson & Ben McLannahan, *Trump Appointee Gary Cohn to Stay Clear of Goldman Matters*, FIN. TIMES (Feb. 23, 2017), https://www.ft.com/content/f83b253e-f9a4-11e6-9516-2d969e0d3b65.

Through the lens of the CFTC's substituted compliance doctrine, comparability approvals of what is sure to be lax post-Brexit U.K. swaps rules will present an untenable risk, which will ultimately fall on the U.S. taxpayer.

XII. The Lone Surviving Exterritorial Remedy: State *Parens Patriae* Actions to Enforce Dodd-Frank's Extraterritorial Provision

As mentioned above,[577] the final adoption of the CFTC's October 18, 2016 proposed rule and interpretations of Dodd-Frank's extraterritorial framework would have eliminated the "de-guarantee"[578] and "ANE" loopholes.[579] With the subsequent election of President Donald Trump and with President Trump's control of the CFTC by his nominations thereto, the October 18, 2016 proposal will almost certainly never see the light of day as a final rule during his Presidency. Moreover, with Republicans in control of both the House and Senate, there will be no near-term Congressional-led "fix" to the deguarantee and ANE problems.[580] Even if the Democrats were to control both Houses after the mid-term and repeal the loopholes in question, that legislation would almost certainly be vetoed.

However, there is one important remedy still available. The Commodity Exchange Act, as amended by Dodd-Frank, expressly allows a State (through its Attorney General, or its securities or other appropriate financial regulatory officials)[581] to bring in federal district court an action, with exceptions not relevant here,[582] to enjoin violations of Dodd-Frank insofar as residents of that state "may be threatened [to be] adversely affected" by those violations.[583]

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577 *See supra* notes 443-45 and accompanying text.

578 *Id.*

579 *Id.*

580 *See supra* notes 450-55 and accompanying text.

581 7 U.S.C. § 13a-2.

582 7 U.S.C. § 13a-2. Under that provision, states may *not* sue exchanges, clearinghouses, floor brokers or floor traders. But, states would be free to sue the four large, systemically-risky U.S. bank holding company swaps dealers that are the subject of this paper and that are defying Dodd-Frank and the CFTC for misreading the extraterritorial provision of Dodd-Frank.

583 *Id.*

It is now common knowledge that the states' attorneys general, for example, have been and are frequent litigants in federal court to enforce federal constitutional or statutory mandates.[584] Their intense involvement in challenging many of the Wall Street practices that led to, or have aggravated, the 2008 financial crisis is well documented.[585] Given the clarity of the Dodd-Frank's extraterritorial provision that requires Dodd-Frank to be applied to "foreign" swaps transactions that could have a "substantial and adverse" effect on U.S. commerce, or are an evasion of that statute, the case to invalidate the CFTC's adherence to the bank's "deguarantee" and ANE loopholes or to the "substituted compliance" doctrine is straightforward. The states are therefore likely to be the last bastion of defense against another financial meltdown from poor swaps regulation that results either in a second multi-trillion-dollar U.S. taxpayer bailout of Wall Street (and corresponding Second Great Recession); or, in the absence of such a bailout, the onset of the Second Great Depression.

Conclusion

By their own design, large U.S. bank holding company swaps dealers and their representatives have crafted their own massive loopholes from Dodd-Frank swaps regulations, which they can exercise at their own will. By arranging, negotiating, and executing swaps in the U.S. with U.S. personnel and then "assigning" them to their "foreign" newly "deguaranteed" subsidiaries, these swaps dealers have the best of both worlds: swaps execution in the U.S. under the parent bank holding companies' direct control, but the ability to move the swaps abroad out from under Dodd-Frank. As history has demonstrated all too well, unregulated swaps dealing almost always ultimately leads to extreme economic suffering and then too often to systemic breaks in the world economy, thereby putting U.S. taxpayers, who suffer all the economic distress that recessions bring, in the position of once again being the lender of last resort to these

[584] Charles Krauthammer, Editorial, *Revolt of the Attorneys General*, WASH. POST, Mar. 3, 2017, at A17; Cornell W. Clayton & Jack McGuire, *State Litigation Strategies and Policymaking in the U.S. Supreme Court*, 11 KAN. J.L. & PUB. POL'Y 17, 17 (2001); Cornell W. Clayton, *Law, Politics and the New Federalism: State Attorneys General as National Policymakers*, 56 REV. POL. 525, 552 (1994).

[585] *The Final Bill*, ECONOMIST, Aug. 13, 2016, at 60; Jean Eaglesham, *Ruling in Rate Probe Doesn't Slow Cases*, WALL ST. J., April 4, 2013, at C1; Danielle Douglas & Brady Dennis, *To Rein in Big Banks, States Go Solo*, WASH. POST, Aug. 22, 2012, at A10; *The National Mortgage Pact: A Glimpse of Four Key Players in the Accord*, WALL ST. J., Feb. 10, 2012, at A2; Michael Powell, *The States vs. Wall St.*, N.Y. TIMES, Oct. 12, 2010, at B1; Brooke A. Masters, *States Flex Prosecutorial Muscle; Attorneys General Move into What Was Once Federal Territory*, WASH. POST, Jan. 12, 2005, at A1.

huge U.S. institutions. The Obama CFTC tried to put an end to these loopholes through a proposed rule and interpretations in October 2016. However, those efforts which were subject to time consuming and statutorily required administrative processes, were never finalized by the time Donald Trump assumed the Presidency. There will almost certainly be no relief from these dysfunctions during the Trump Administration or Congress. However, state attorneys general and various state financial regulators have the statutory legal tools to enjoin these loopholes and save the world's economy and U.S. taxpayers from once again suffering a massive bailout burden and an economic Armageddon.