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CHANGING LANDSCAPE OF SWAP REGULATION

The Dodd-Frank Act mandates that swaps must be traded on transparent trading facilities, centrally cleared when possible, and swap information stored in data repositories. As required by the Act, the SEC and CFTC have proposed conflict-of-interest rules to prevent swap market participants from controlling clearing or trading facilities and proposed extending anti-fraud and anti-manipulation rules to cover the swap markets.

By Pravin Rao and Assad Clark *

Looking back over the 2008 financial crisis, it is apparent that its pervasiveness was due in large part to financial institutions' inability to measure risks accurately as well as the lack of controls designed to keep known risks in check. Financial behemoths steeped themselves in risk by entering into a swaps market that lacked the centralized infrastructure needed for market participants to determine the type of swap positions other institutions held, the number of other entities holding similar positions, or the identity of the respective counterparties. At the peak of the financial crisis, the intersection of these conditions as well as the absence of any meaningful regulatory framework resulted in the loss of trillions of dollars of wealth.

As a result of this perfect storm, Congress recognized the need for greater transparency in the swaps market as well as the need to decrease the overall interconnectedness of parties engaging in swaps transactions. These issues were addressed in the summer of 2010 when Congress passed Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), which mandates that swaps must be traded on transparent trading facilities and centrally cleared when possible, and that this and other swap information must be stored in data repositories. The Act also enlarges the CFTC and SEC's jurisdiction so that they may implement and enforce these changes. Patterns have begun to emerge that provide clues as to what the regulatory framework will look like, and what it will mean for securities litigators as well as in-house counsel of all businesses that engage in swap agreements – especially at financial institutions. The regulators will have unprecedented access to information on the functioning of the swaps markets, which will, at a minimum, result in increased scrutiny as regulators hope to bring stability to a market plagued by so much volatility in recent years.

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IN THIS ISSUE

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LACK OF REGULATION – THE HISTORICAL REASONS

Since the days of the first swap agreements in 1981, there has been a dearth of laws regulating them. The Commodity Futures Modernization Act of 2000 ("CFMA") instituted sweeping anti-fraud and anti-manipulation provisions for the derivatives market, but swaps were specifically excluded.[1] As a result, there was virtually no oversight for swaps transactions, which, as of June 2010, accounted for over two-thirds of the $583 trillion global market in OTC derivatives.[2] This lack of regulation was based on a collection of beliefs about swaps that the financial crisis has most recently dispelled. Regulators believed that since swaps were executed by sophisticated parties with roughly equal access to information, there was no need for government intrusion; these market participants would effectively operate as a check and balance on each other.[3] Banking regulators also felt that because the financial institutions themselves were regulated, there was no need to further regulate the swaps market. These views were combined with a fear that regulating swaps would push this huge market overseas, causing the U.S. to lose out on the economic growth and liquidity that swaps provided. These beliefs, combined with the absence of federal oversight, created the conditions that allowed a financial powerhouse such as AIG to assume too much risk with its own credit default swap ("CDS") positions.

AIG: Impacted by Trading Credit Default Swaps

From the early 2000s through 2007, many investment banks and other packagers of securitized mortgage products realized that the collateralized debt obligations ("CDOs") they were selling would be less risky and more attractive to buyers if it was bundled with a CDS. By doing this, investors were supposedly put in a "no lose" situation. If the CDOs performed as expected, the investor made money. If the underlying mortgages defaulted, preventing the CDO from being able to meet its financial obligations, the investor was paid from the CDS. The CDS was nothing more than a fee in exchange for a payment if a credit default event occurred.

As the sub-prime mortgage industry boomed with the use of CDOs and CDSs, AIG became an integral player helping to fuel this growth. By 2007, AIG's credit book, which had peaked at $527 billion, was full of corporate debt, regulatory capital, and multi-sector CDOs.[4] However, as the real estate market started to crumble, AIG was forced to pay out on more CDSs than it had projected. This caused its credit rating to slip and triggered provisions in many of its CDSs, which, in turn, forced AIG to ante up additional collateral. This vicious cycle quickly led to AIG not having enough cash on hand to meet its CDS obligations as it simultaneously became more expensive for it to borrow money. Given AIG's huge book of credit – including, city, state, and national governments – the government realized that if it allowed AIG to default on its payments, this would have a domino effect that would cause catastrophic losses in both U.S. and foreign markets. To avoid this and other dire consequences, the U.S. Treasury took over AIG as

[1] The CFMA also prohibited the SEC from proactively enforcing its fraud provisions over swaps. Section 303 of the CFMA amended the Securities Exchange Act of 1934 to add Section 3A, which stated that "[t]he Commission is prohibited from registering, or requiring, recommending, or suggesting the registration under this title of any security-based swap agreement (as defined in Section 206B of the Gramm-Leach-Bliley Act)." CFMA, Pub. L. 106–554, 114 Stat. 2763; Commodity Exchange Act § 2(g).

[2] BANK FOR INTERNATIONAL SETTLEMENTS, TRIENNIAL AND SEMIANNUAL SURVEYS: POSITIONS IN OVER-THE-COUNTER (OTC) DERIVATIVES MARKETS AT END – JUNE 2010 at 2 (November 2010 Release).

[3] *President's Working Group on Over-the-Counter Derivatives Markets and the Commodity Exchange Act: Hearing Before the S. Comm. on Agriculture, Nutrition and Forestry*, 106th Cong. 13-14 (2000) (statement of Alan Greenspan, Chairman of the Fed. Reserve), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=106_senate_hearings&docid=f:67569.pdf.

[4] Gary Gensler, *History of Derivatives Regulation, Culprit OTCs*, COMMODITY ONLINE, July 2, 2010, http://www.commodityonline.com/news/History-of-derivatives-regulation-culprit-OTCs-29636-3-1.html.

part of a $182.5 billion taxpayer-funded bailout.[5] Of the total amount that was provided, AIG used $127.4 billion to stay solvent, of which $40 billion went to private and foreign financial institutions that were counterparties to AIG's CDS holdings.[6]

It is debatable whether additional regulatory oversight could have prevented AIG's collapse or even drastically reduced the amount of money it lost on the CDSs it sold.[7] After all, government gatekeepers still would have needed access to the right information and been prepared for the impending storm that was coming – something that was missed by many insiders and regulators alike. But if swaps had been required to be centrally cleared and sellers had to post margins for swaps that were not cleared, AIG's exposure would have diminished and there would have been less need to bail out one actor like AIG or the entire industry.

CONGRESSIONAL REFORM – THE DODD-FRANK ACT

On July 21, 2010, President Obama signed the Dodd-Frank Act into law to fix the perceived regulatory holes in the securities markets that allowed the financial crisis to have such far-reaching and disastrous effects.[8] The Act addresses derivative swaps directly by seeking to reduce three different types of risk: market risk, credit risk, and operational risk.[9]

"Market risk," is the exposure to losses due to the volatility in the underlying currency, interest rate, commodity, or security to which the derivative is pegged. To reduce market risk, the Act seeks to increase transparency by (1) trading most swaps on swap execution facilities ("SEFs")[10]; and (2) centrally collecting and storing swap market information in swap data repositories ("SDRs").[11] Trading swaps on SEFs, as opposed to over-the-counter, will give participants a clear sense of what type of trading activity is happening in as close to real-time as possible so they can hedge their positions to adjust for those known risks. In turn, SDRs aggregate and store historical SEF and other market data (*e.g.*, information about the underlying security, the price of the swap, the time the trade was executed, etc.) so that it can be researched and trends observed.[12] This information allows market participants who were not parties to the swap agreement to compare multiple swaps, which should create greater price uniformity among swaps that have commensurate risk.

"Credit risk," occurs when a seller incurs a financial loss due to a borrower's failure to meet a contractual obligation (*e.g.*, repaying a loan). To reduce credit risk, the Act seeks to diminish the interconnectedness that entities have to each other by mandating that swaps are centrally cleared, or maintain margin requirements if they cannot be centrally cleared.[13] This ensures that if a party defaults, the counterparty will still receive the cash flow stream either from the clearing agency, which acts as a guarantor, or in the case of non-centrally cleared swaps, from the required capital margins. In this way, one party's default will have less of an impact on other financial institutions.

"Operational risk," arises when economic losses are incurred because an entity or structure has insufficient internal controls in place.[14] The value of swaps can be affected by conduct that extends beyond the purchase and sale of the underlying security or commodity, which,

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[5] *Federal Financial Assistance: Preliminary Observations on Assistance Provided to AIG*, Hearing Before the Subcomm. On Capital Markets, Ins., and Gov. Sponsored Enterprises of the H. Comm. on Financial Services, 111th Cong. 3-4 (2009) (statement of Orice M. Williams, Director, Financial Markets and Community Investment, U.S. Gov. Accountability Office), *available at* http://www.gao.gov/new.items/d09490t.pdf.

[6] Press Release, American International Group, *AIG Discloses Counterparties to CDS, GIA and Securities Lending Transactions* (Mar. 15, 2009).

[7] The main causes for AIG's collapse and the overall financial crisis are still topics of debate, but it is undisputed that credit default swaps played a significant role in all this.

[8] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

[9] Press Release, U.S. Department of the Treasury, The President's Working Group on Financial Markets: *Policy Objectives for the OTC Derivatives Market* (November 14, 2008) *available at* http://treas.tpaq.treasury.gov/press/releases/reports/policy objectives.pdf.

[10] For the purposes of this article, "swap execution facilities," will be used to describe swap execution facilities, swap exchanges, and derivative boards of trade, which essentially perform the same function of providing a shared medium for trading swaps.

[11] Dodd-Frank Act §§ 733 and 763(a), describing SEFs and security-based SEFs, respectively.

[12] *Id*. § 727.

[13] *Id*. §§ 723 and 763(a). These sections grant the CFTC and SEC the authority to set margin requirements as each agency sees fit.

[14] John Kiff, *et al.*, *Credit Derivatives: Systemic Risks and Policy Options?* at 8 (International Monetary Fund, Working Paper No. 09/254, 2009), *available at* http://www.imf.org/external/ pubs/ft/wp/2009/wp09254.pdf.

along with the prohibition of misleading information, is the conduct that existing laws and regulations forbid in those respective markets. To reduce the possibility of market manipulation and fraudulent activity, the Act has given the CFTC and the SEC the authority to promulgate rules that proscribe fraudulent and manipulative behavior in the swaps market, including fraudulent behavior that occurs during the period a swap is held and not just at its purchase and sale.[15]

INCREASED ROLE OF THE SEC AND CFTC

Although the Act provides an outline for what Congress has determined is needed in the swaps market, it leaves the implementation to the agencies with the historical expertise – the CFTC and SEC ("the agencies") – splitting regulatory authority over swaps between them.[16] The SEC has rule-making authority over "security-based swaps" while the CFTC has been left with the remainder. Swaps known as "mixed swaps," with characteristics of both types, will be governed by *both* the CFTC and the SEC – with consultation from the Federal Reserve. However, regardless of swap type, the Act requires the agencies to consult and coordinate with each other to the greatest extent possible.[17]

The murky boundary between definitions that pertain to both "swaps" in general and "security-based swaps" create potential conflicts and disharmony between the CFTC and the SEC. On August 13, 2010, the CFTC and the SEC published a joint advance notice of proposed rulemaking that requested public comments to assist in defining key terms such as "swap," "security-based swap," "major swap participant," and "major security-based swap participant."[18] To date, a security-based swap is defined as anything that is a swap according to the definition found in Section 1a of the Commodity Exchange Act ("CEA") and also is a derivative of an index of securities consisting of nine or fewer securities and meets certain other requirements.[19] If a swap is a derivative of an index of 10 or more securities or has any other characteristic of a swap and a security-based swap then it is defined as a "mixed swap," over which both the SEC and CFTC have jurisdiction.[20] If a swap is not based on any security, but is a derivative of something else such as a commodity, a currency, or an interest rate, it is termed a "swap," and falls under the CFTC's sole jurisdiction.

The definitions for "major swap participant" and "major security-based swap participant" are much easier to reconcile. Sections 721 and 761 of the Act amended Section 3C of the Securities Exchange Act and Section 1a of the CEA to define "major swap participant" and "major security-based swap participant." The definitions are nearly identical with a "major swap participant" being defined as a non-dealer that either (1) maintains a substantial position in one of the major categories of swaps as defined by the CFTC or the SEC, (2) has swap positions that create "substantial counterparty exposure" that could seriously harm the national financial markets, or (3) is a financial entity that has high leverages and is not subject to capital requirements by an appropriate federal banking agency.[21]

Among the many rules the agencies have proposed, or will propose in the future, are those that attempt to address ways market participants may subvert the swaps market. One type of subversion occurs when market participants try to manipulate the market by affecting the price of a swap or the underlying object (*i.e.*, commodity, currency, security, etc.) through deceptive practices, fraudulent activity, or price-fixing. The second type of subversion occurs when a market participant buys and sells a large portion of swaps, obtains control over one of the centrally positioned entities, and then governs it in a way that increases or restricts access to the swaps market for its economic gain.

There are five ways that a market participant that controls a trading facility or clearing agency (collectively called "Centralized Entities") can manipulate the entity's internal process for financial gain. The first two are general to all Centralized

[15] The Act amends the fraud enforcement provisions contained in Section 17A of the Securities Act, Section 10b of the Exchange Act, and Section 6 of the Commodity Exchange Act. Dodd-Frank Act §§ 753, 763(g).

[16] *Id*. § 712(a)(1)-(2).

[17] *Id*.

[18] Dodd-Frank Act §§ 721 and 761; *Advance Joint Notice of Proposed Rulemaking; request for comments*. SEC and CFTA Rel. No. 34-62717, File No. S7-16-10.

[19] Dodd-Frank Act § 761 newly amending Securities Exchange Act § 3(a)(68)(A); CEA § 1a(25).

[20] Dodd-Frank Act § 721 newly amending CEA § 1a(47)(D).

[21] Dodd-Frank Act § 765; SEC and CFTC Joint Proposed Rule, Rel. No. 34-63452, File No. S7-39-10. In addition, the two agencies have recently issued some clarifications on how they think "substantial positions" and other terms should be defined, and the comment period closed on February 22, 2011. *Id.* As of this writing, the final rules have not yet been issued.

Entities, the next two are specific to clearing agencies, and the last one is specific to trading facilities. First, if a market participant can limit a particular swap's ability to be cleared or traded on a Centralized Entity, the value of the swap will be lower. Second, a market participant could limit the scope of products that a Centralized Entity it controlled could make eligible to be cleared or traded in an effort to manipulate the overall market. Third, participants that controlled a clearing agency could raise or lower collateral requirements for the swaps it cleared for the purpose of excluding certain swaps they knew could not meet the heightened requirements. Fourth, these participants could also raise or lower the collateral requirements the clearing agency had to maintain for its own risk management if such actions were in their financial interest. Lastly, a trading facility could attempt to cut costs by not properly fulfilling its own regulatory reporting duties.

To prevent such manipulation and control, the agencies proposed rules to add checks and balances on Centralized Entities to prevent conflicts of interest from arising and to prevent any market participant from being able to exert control over any Centralized Entity. The SEC has proposed three rules, collectively called Regulation MC under the Exchange Act, to mitigate conflicts of interest regarding the ownership, voting, and governance with respect to the Centralized Entities within its jurisdiction.[22] The CFTC has proposed similar rules to restrict certain entities from controlling Centralized Entities within its jurisdiction.[23]

Voting and Governance Limits

A market participant can control a Centralized Entity by having a majority of its voting rights, or a majority interest, in its governance. To prevent this conflict of interest, the agencies have proposed rules to limit ownership and voting interest on the one hand, or governance interest on the other, or a mix of the two. The proposed rules provide alternatives so that industry participants can comment and choose a scenario that they find most suitable and give an explanation why. The proposals give options limiting a participant's voting power from 5% to 20% of any class of equity interest.[24] There is one significant difference between the CFTC and SEC proposals with respect to limitations on voting interest. The CFTC gives its clearing agency a choice between an individual cap of being able to direct the vote of more than 20% on any class of its equity interest or an aggregate equity interest cap of 5%.[25] The SEC doesn't provide different options with respect to voting interest caps for clearing agencies, and proposes the same 20% individual cap the CFTC mentions, while also additionally barring any two unrelated clearing agency participants from directing the vote of more than 40% of any class of its equity interest in aggregate.[26]

There is more variance between the CFTC and the SEC on limitations in governance than voting. Similar to the voting limitations, both agencies offer multiple alternatives on governance limitations for industry stakeholders to comment on and choose. In all proposals, however, the board nominating committees must consist of between 51% and 100% of independent directors.[27] The major difference between the CFTC and the SEC is the composition of the risk committees they propose. The CFTC rules call for its clearing agencies to have a risk committee consisting of at least 35% independent directors and 10% customer representatives.[28] Although the SEC would not require clearing agencies to establish a risk committee, if one were created, it would have to consist of at least 35% or 51% independent directors.[29] The significance of the risk committee is that along with the board of directors, it decides the capital requirements that a clearing agency must maintain.

Fraud Provisions Broadened to Account for Swaps

In order to provide the agencies with the authority necessary to proscribe all types of fraudulent activity in the swaps market, the CFTC proposed rules 180.1 and 180.2, and the SEC proposed rule 9j-1 (the "Anti-Fraud

[22] Dodd-Frank Act § 765; SEC proposed rule, Rel. No. 34-63107, File No. S7-27-10.

[23] Dodd-Frank Act § 726(a). The restricted entities are bank holding companies with assets of $50 billion or more, non-bank financial companies supervised by the Board of Governors of the Federal Reserve System, swap dealers, major swap participants, and affiliates. CFTC, *Requirements for Derivatives Clearing Organizations, Designated Contract Markets, and Swap Execution Facilities Regarding the Mitigation of Conflicts of Interest*, 75 Fed. Reg. 200 (proposed Oct. 18, 2010).

[24] SEC proposed rule §§ 242.701-242.702; CFTC proposed rule §§ 37.19(d), 38.851(d).

[25] CFTC proposed rule §§ 39.25(b)(2)(i)(A) and 39.25(b)(2)(i)(B).

[26] SEC proposed rule 202.701(a)(1).

[27] CFTC proposed rule § 40.9(c); SEC proposed rule §§ 202.701(a), 202.701(b)(4)(i).

[28] CFTC proposed rule § 39.13(g).

[29] SEC proposed rule §§ 242.701(a)(5), 242.701(b)(5).

Rules").[30] All three of these rules borrow language from the fraud provisions found in the Securities Act, the Exchange Act, and the CEA. The rules satisfy the provisions of the Dodd-Frank Act, which calls for the jurisdiction of the SEC and the CFTC to be broadened to proscribe conduct pertaining to fraudulent and deceptive behavior, market manipulation, and price-fixing for all types of swaps. Both agencies recognized that, unlike with securities and commodities, swaps require ongoing payments from one party to another. This required the agencies to proscribe fraudulent behavior that took place *during* the period a swap was held and not just at its purchase or sale.

Rule 9j-1 proscribes the same type of conduct that Section 10b of the Exchange Act proscribes with the addition of extending that language to include security-based swaps as well as securities. Rule 9j-1 consists of four clauses. Clauses (a) and (b) are modeled after the fraud provisions of the Securities Act and Exchange Act, and like those provisions, they proscribe anyone from affirmatively engaging in fraudulent conduct or making statements that will obscure a material fact. Both of the first two clauses also incorporate the scienter and materiality requirements that prevailing case law has held are present in Section 10b of the Exchange Act and the first two subsections of Rule 10b-5.[31] Moreover, since a security-based swap can be manipulated by more than just fraudulent activity involving its purchase and sale, Rule 9j-1 takes this into account and applies to all of the ongoing obligations and rights that security-based swaps have in that interim period.

The third clause of 9j-1 makes it unlawful for a market participant to negligently make a misleading statement and profit from the statement. Unlike the first two clauses of 9j-1, it is modeled after subsection 17(a)(2) and 17(a)(3) of the Securities Act, which the Supreme Court has held does not require scienter for a violation.[32] In this way, the SEC could bring an enforcement action under Rule 9j-1 if information in connection with a security-based swap – or the security underlying it – was manipulated in a way that led to a reasonably foreseeable price fluctuation in the derivative. This is logical because any manipulation of the value of the cash flow streams that a security-based swap is obligated to make will affect its price. The last section of Rule 9j-1 makes it unlawful "[t]o engage in any act, practice, or course of business which operates or would operate as fraud or deceit upon any person." This allows the SEC to pursue conduct that may not be covered under the first three sections, and like the third clause, there is no scienter requirement.

The CFTC's proposed Rules 180.1 and 180.2 broaden that agency's current mandate to protect the commodities market from manipulation. These rules expand the CFTC's enforcement ability – to equal that of the SEC's for the first time – by giving the commission the new authority to proscribe fraudulent behavior, while reiterating its long-standing ability to guard against price manipulation.[33]

The first rule satisfies the newly drafted Section 6(c)(1) of the CEA, which seeks to proscribe fraudulent behavior and also states that rulemaking is mandatory and must be completed within one year after the Dodd-Frank Act was enacted.[34] Following in the footsteps of other administrative agencies,[35] Rule 180.1 mimics the language and elements of Rule 10b-5 and diverges from that template only enough to keep the CFTC's proposed rule in line with its distinct regulatory mission. The comments that the CFTC has issued with the proposed rule make it clear that this proposal is meant to include the materiality and scienter elements that prevailing law has interpreted in Rule 10b-5 of the Exchange Act to be included in Rule 180.1 as well. The CFTC also advocates an objective definition of materiality while explicitly stating that "puffery" will not trigger the element.[36] However, the CFTC has argued that "an

[30] CFTC proposed rules § 180.1 and 180.2 are promulgated pursuant to CEA §§ 6(c)(1) and 6(c)(3), which was added by the Dodd Frank Act § 753 and the CFTC's general rulemaking authority under CEA § 8(a)(5). SEC proposed rule § 9j-1 is promulgated pursuant to § 9(j) of the Securities Exchange Act, which was added by the Dodd Frank Act § 763(g).

[31] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 201 (1976); *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), respectively. The proposed rule adds "manipulate" to the proscribed conduct in clause (a) and "knowingly or recklessly" to describe the intent requirement in clause (b). The Commission views these additions as merely reflective of current case law.

[32] *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980).

[33] 75 Fed. Reg. 67657, 67662. "The proposed rulemaking promotes fair and efficient markets, for the first time allowing the Commission to protect against fraud-based manipulation." *Id*.

[34] § 6(c) of the Commodity Exchange Act was amended pursuant § 753 of the Dodd-Frank Act.

[35] Energy Policy Act of 2005, Pub. L. 109-58, 119 Stat. 594 at §§ 315 and 1283; and Energy Independence and Security Act of 2007, Public Law 110-140, 121 Stat. 1492 at §§ 811 and 812.

[36] 75 Fed. Reg. 67657, 67660.

omission be considered material if there is a substantial likelihood that the omitted fact would have been viewed by a reasonable person as having significantly altered the total mix of information available."[37]

Proposed Rule 180.2 reaffirms one of the CFTC's originally stated aims, to prohibit price manipulation, by repeating the language found in Section 6(c)(3) of the CEA. The CFTC plans on continuing to enforce the prohibition on attempted and actual price manipulation according to long-standing legal precedent, which finds that conduct that is not fraudulent or otherwise illegal can still be price manipulation.[38]

IMPACT OF PROPOSED RULES

As an initial matter, the above-referenced efforts to combat conflict of interest and fraud will significantly change the reporting requirements and conduct of end users and the legal counsel that represent them. While the conflicts-of-interest rules will not create specific additional duties for most market participants since the majority of them will not be acting as clearing agencies or managing trading facilities, it will still impact them more generally by affecting the shape and structure of the overall swaps marketplace. On the other hand, the anti-fraud and anti-manipulation provisions will affect the day-to-day behavior of all market participants given that the reach of the SEC and the CFTC is significantly extended with the additional scrutiny that comes with those provisions. It is worth noting, however, that these two groups of rules are part of dozens of rules currently being proposed and none of them will be implemented before the summer of 2011. Even after that date, it will take years before the body of case law surrounding these rules develops such that legal precedent can be relied upon with any certainty.

Impact of the Conflicts Rules

The proposed rules on conflicts of interest ("Conflicts Rules") will have a direct effect on the largest financial institutions by limiting the extent to which these institutions can control or influence Centralized Entities. The intended impact of these rules is to prevent the financial institutions that have historically dominated the swaps industry from excluding other participants from becoming clearing agencies. This is a charge that has been currently leveled against financial institutions that have been authorized to clear swaps in the interim until these proposed rules are implemented.[39] The response from a majority of the clearinghouses was that the banks trying to become clearinghouses were not sufficiently capitalized. This is a valid argument that would hold more credence if the risk committees of the interim clearinghouses consisted of 35% or more independent directors, as will be necessary when the final rules are implemented in July of 2011.[40] The risk committee decides how much collateral a clearing agency must hold, and how much collateral it must require from the sellers of swap agreements using it to clear swaps. If there were a large percentage of independent directors involved in determining the capital requirement of a clearing agency, it would be easier to argue the objectivity of the committee's final decision.

The impact that the Conflicts Rules will have on the swaps market depends on how each agency limits ownership and voting interest that any "influential market participant" can have as well as the number of directors and nominating committee members that must be "independent" or "public" directors.[41] Since the Conflicts Rules provide for multiple alternatives for how much control certain market participants can exert over board committees of the Centralized Entities, the potential impact of these rules raises many questions. For example: Do restrictions on owning and voting have the same effect as restrictions on governing? Do individual caps on classes of equity within a clearing agency create different incentives compared to aggregate caps on the total equity of the entity? Is there a reason why the CFTC requires a majority of the nominating committee of the board of directors to be independent directors while the SEC requires *all* of the nominating committee to be independent?[42]

The Conflicts Rules should keep the cost of swap agreements lower by preventing unnecessary litigation over whether an influential market participant is engaging in fraudulent activity by forcing its

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[37] *Id*. at 67660, citing *TSC Indus., Inc.* 426 U.S. at 449; *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

[38] *Cargill, Inc. v. Hardin*, 452 F.2d 1154 (8th Cir. 1971); *G.H. Miller & Co. v. U.S.*, 260 F.2d 286 (7th Cir. 1958).

[39] Louis Story, *A Secretive Banking Elite Rules Trading in Derivatives*, N.Y. TIMES, Dec. 11, 2010.

[40] *Id.* The membership of the risk committees for the interim clearinghouses has not been disclosed.

[41] The term "influential market participant" is used to describe all entities enumerated in CFTC proposed rule § 39.25(b) as well as "security-based swaps dealers" and "major security-based swap participants," which are referenced in SEC proposed rules §§ 242.700 – 242.702.

[42] *See* SEC proposed rules §§ 242.700 – 242.702; CFTC proposed rule § 40.9(c).

counterparty to choose a clearing agency over which it has influence. The Dodd-Frank Act grants counterparties who are on the other side of transactions to influential market participants the power to choose the agency that clears the swap agreement.[43] This helps level the playing field and prevents an influential market participant from funneling all of its swap transactions to certain clearing agencies it has a financial incentive to help. However, even with this provision, an influential market participant could still leverage its market power to force smaller market participants to use its clearing agencies. Inevitably, this would lead to litigation when one of the smaller market participants sued under the Anti-Fraud rules. The costs of the resulting litigation would drive the price of swap agreements higher. But since, under the Conflicts Rules, an influential market participant is not able to control a Centralized Entity, and has less of an economic incentive for compelling its selection, the chances of coercion are drastically reduced.

Impact of the Anti-Fraud Rules

The Anti-Fraud rules will have a direct effect on every market participant in the swaps marketplace by expanding the scope of liability for all market participants. The CFTC's power to prosecute fraud has been drastically increased, and the agency is likely to be given a budget increase to help it meet this mandate. The CFTC's proposed Anti-Fraud rules (180.1 and 180.2) also greatly expand the potential cast of defendants that can incur liability. The SEC's proposed Anti-Fraud rule (9j-1) likewise increases the scope of conduct that can be termed fraudulent.

One impact the CFTC's Anti-Fraud rules will have will be an increase in the CFTC's personnel and visibility, which will require more practitioners in the securities field to develop an increased familiarity with the agency's practices and methods. While the CFTC always had the power to police market participants over price-fixing in commodities, the Act extends this authority to swaps.[44] By borrowing much of the language for its Anti-Fraud rules from the Exchange Act's Rule 10b-5, it is a clear signal that the CFTC expects to step up its enforcement efforts to more closely mirror that of the SEC. The CFTC's enforcement budget for the 2010 fiscal year was less than 20% of the SEC's enforcement budget.[45] If the CFTC is going to have an anti-fraud provision that is at least as expansive as the SEC's, it would follow that the CFTC will need a budget commensurate to its newly granted powers.

Another impact of the Anti-Fraud rules may be to extend private rights of action against secondary violators, actions that the courts have held could not be brought under the Exchange Act. The Supreme Court has held that Section 10b and Rule 10b-5 of the Exchange Act did not extend private rights of action against individuals to include those who may aid in the fraud but are not "primary violators."[46] Section 25(a) of the CEA explicitly allows for private rights of action against individuals who aid in violating the CFTC's fraud provisions.[47] This could potentially expose financial institutions and other secondary actors to private investor suits where none were possible before.[48] Consider the case of a hedge fund or mutual fund that entered into swaps under the CFTC's jurisdiction, such as a CDS or a foreign-exchange swap, to hedge a portfolio that otherwise consisted solely of securities. Any fraudulent or manipulative behavior that caused the securities to change price would also cause fluctuations in the price of the swaps used to hedge the portfolio's risk. Under the CEA, investors in the mutual fund or hedge fund would have a private right of action against secondary violators where one did not previously exist.

Although it might not seem as large an increase as the CFTC, the SEC's power will also grow with proposed Rule 9j-1, which would extend the SEC's reach over conduct related to manipulating prices of security-based swaps as well as securities. In the way Rule 10b-5 of the Exchange Act has been judicially interpreted to prohibit manipulative conduct with respect to securities, Rule 9j-1 explicitly proscribes the same conduct as to security-based swaps. While Rule 10b-5(b) has been judicially interpreted to require scienter, Rule 9j-1 specifically includes the language "knowingly or recklessly" in

[43] Dodd-Frank Act § 763(a).

[44] Dodd-Frank Act § 717.

[45] FY 2010 SECURITIES EXCH. COMM'N CONG. JUSTIFICATION (May 2009) at 37; COMMODITY FUTURES TRADING COMM'N FY 2011 PRESIDENT'S BUDGET AND PERFORMANCE Plan (Feb 2010) at 77.

[46] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). The PSLRA restored Commission rights of action by extending liability to "any person who knowingly provides substantial assistance to another in violation…." The Dodd-Frank Act amended that phrase to "knowing or reckless" substantial assistance. Securities Exchange Act § 20(e).

[47] CEA § 25(a).

[48] Floyd Norris, *A Novel Way to Sidestep Investor Suits*, N.Y. TIMES, Dec. 2, 2010.

clause (b) so as to make the scienter requirement clear and avoid litigation over the rule's meaning.

PREPARING FOR THE CHANGING REGULATORY LANDSCAPE

While it is not yet certain what the final rules will be or exactly how the SEC and CFTC will regulate swaps, there is every reason to believe that regulators are serious about policing this previously unfettered market. Rather than wait for the final word, the better course is for market participants, clearing firms, financial institutions, and legal practitioners in this area to prepare themselves for the heightened scrutiny that is surely not far away. Among the distinctions to become aware of in this changing regulatory environment are:

- Be prepared to deal with both the SEC and CFTC in regulation and enforcement of swaps, and how disputes between the SEC and the CFTC over enforcement efforts will be resolved.

- Understand how one can negligently violate the CFTC and SEC's Anti-Fraud Rules.

- Understand the scope of who will be regulated and what conduct is newly proscribed. In particular, the terms "major swap participants" and "major security-based swap participants" are defined broadly, and hedge funds and other large entities that use derivatives could be caught in one of these definitions and subject to regulation and registration requirements.

- Be aware of how "secondary violators," such as inside and outside legal counsel to financial institutions and managers of funds, might be exposed to liability in SEC and CFTC actions and in private rights of action under the CEA.

- Understand the additional reporting requirements that a clearing firm must satisfy.

- Know which derivative contracts are subject to new clearing requirements and which will be exempt.

- Know which derivative contracts must be traded on trading facilities.

- Keep updated on promulgation of proposed rules. These will be modified during the rule-making and commenting process over the next year. ■