
TO CLEAR OR NOT TO CLEAR: HOW SEC
IMPLEMENTATION OF DODD-FRANK
UNDERMINES TITLE VII'S MANDATORY
CLEARING REQUIREMENT

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In 2010, the United States Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act to prevent a recurrence of the 2008 financial collapse. Since its passage, the Act's many reforms have reshaped the financial markets, but faulty executive implementation has undermined some of these components. One such issue arose in the United States Securities and Exchange Commission's interpretation of Dodd-Frank's Title VII central clearing mandate, which Congress included to stabilize and bring transparency to the over-the-counter derivatives market. The SEC has not yet effected mandatory clearing of security-based swaps—the financial products which Dodd-Frank subjected to the agency's jurisdiction—but the SEC's publicly contemplated approach omits “commission-initiated review,” a core component of Title VII's structure. Without this type of review, many security-based swaps will remain outside the scope of mandatory central clearing, causing the SEC to fall short of its statutory mandate and Congress' intent. This Note urges the SEC and lawmakers to take the necessary steps to address the “commission-initiated review” missing link and ensure the regulatory regime successfully includes the entire scope of financial products subject to the SEC's jurisdiction.

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I. INTRODUCTION

A number of complex and diverse factors created and deepened the 2008 financial crisis. Academics' and regulators' attempts to identify the most important contributing factors generated significant discussion and disagreement.¹ However, a general consensus emerged on one point—derivative products played a central role in exacerbating the crisis.² At some of the most turbulent moments, the highly interconnected derivatives market served to stoke institutional fear and dramatically increase financial entities' exposure to risky assets.³ Although identifying specific

¹ See, e.g., FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES xvi (2011) [hereinafter FIN. CRISIS INQUIRY REPORT], <https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf> [perma.cc/E7EZ-LE6A] (“While the vulnerabilities that created the potential for crisis were years in the making, it was the collapse of the housing bubble—fueled by low interest rates, easy and available credit, scant regulation, and toxic mortgages—that was the spark that ignited a string of events[.]”); see also James Crotty, *Structural Causes of the Global Financial Crisis: A Critical Assessment of the ‘New Financial Architecture’*, 33 CAMBRIDGE J. ECON. 563, 564 (2009) (“[The financial crisis] deep cause on the financial side is to be found in the flawed institutions and practices of the current financial regime[.]”).

² See, e.g., Anupam Chander & Randall Costa, *Clearing Credit Default Swaps: A Case Study in Global Legal Convergence*, 10 CHI. J. INT'L L. 639, 639 (2010) (“On both sides of the Atlantic, regulators identified credit default swaps (CDS) as a central factor in the crisis that seized Bear Stearns, Lehman Brothers, American International Group (AIG), and ultimately the world.”); *id.* at 639 n.1 (citations omitted) (“CDS became a central culprit in the popular press as well.”); FIN. CRISIS INQUIRY COMM'N, *supra* note 1, at xxiv–xxv (“We conclude over-the-counter derivatives contributed significantly to this crisis. . . . [W]hen the housing bubble popped and crisis followed, derivatives were in the center of the storm.”).

³ Steven McNamara, *Financial Markets Uncertainty and the Rawlsian Argument for Central Counterparty Clearing of OTC Derivatives*, 28 NOTRE DAME J.L. ETHICS & PUB. POL'Y 209, 225–26 (2014) (“[Derivatives] were

solutions proved to be a difficult undertaking after the crisis, those studying derivatives' role in the crisis voiced a variety of concerns, which, if addressed, could help prevent future crises and reduce systematic instability.⁴

In response to the so-called Great Recession, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").⁵ One of Dodd-Frank's central reforms, codified in Title VII, requires parties trading certain over-the-counter ("OTC") derivatives to clear and execute the transactions through central clearinghouses.⁶ However, the Act did not define which OTC derivatives would be subject to the central clearing mandate. Instead, Congress delegated this definitional task to two federal agencies: the Commodity Futures Trading Commission (the "CFTC," responsible for "swaps"), and the Securities and Exchange Commission (the "SEC," responsible for "security-based swaps").⁷ Under Title VII's structure, both agencies are required to make their central clearing determinations on the basis of two different inputs: (1) submissions received from clearinghouses seeking to voluntarily clear swaps or security-

indirectly involved in the financial crisis in a number of ways, though, the most important of which was simultaneously the least well understood: their role in creating a highly interconnected financial system that fostered a climate of extreme fear[.]").

⁴ See, e.g., Chander & Costa, *supra* note 2, at 642 ("[R]egulators on both sides of the Atlantic turned to CDS clearing as one key reform in the wake of the financial crisis.").

⁵ See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁶ See generally Wall Street Transparency and Accountability Act of 2010, Pub. L. No. 111-203 §§ 701, 711-54, 761-74, 124 Stat. 1376, 1641-1802 (2010).

⁷ See 7 U.S.C. § 2(h)(1)(A) (2012) ("It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization . . . if the swap is required to be cleared."); 15 U.S.C. § 78c-3(a)(1) (2012) ("It shall be unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a clearing agency . . . if the security-based swap is required to be cleared.").

based swaps;⁸ and (2) the agency's own review of products that are currently traded by market participants, but are not clearable through a central clearinghouse (and therefore not submitted for review).⁹

The CFTC rapidly implemented its Title VII mandate. In 2011, the agency finalized a rule establishing processes for swap submissions and for top-down review of unclearable products (the "CFTC Process Rule").¹⁰ Beginning with a rule promulgated in 2012 (the "Initial CFTC Clearing Mandate"), the agency used these processes to designate certain swaps for mandatory clearing.¹¹ Additionally, the CFTC issued a subsequent rule in 2016 (the "Additional CFTC Clearing Mandate") to expand coverage to additional swap products.¹²

⁸ See 7 U.S.C. § 2(h)(2)(B)(i) (2012) ("A derivatives clearing organization shall submit to the [CFTC] each swap . . . that it plans to accept for clearing[.]"); 15 U.S.C. § 78c-3(b)(2)(A) (2012) ("A clearing agency shall submit to the [SEC] each security-based swap . . . that it plans to accept for clearing[.]").

⁹ See 7 U.S.C. § 2(h)(2)(A)(i) (2012) ("The [CFTC] on an ongoing basis shall review each swap . . . to make a determination as to whether the swap . . . should be required to be cleared."); 15 U.S.C. § 78c-3(b)(1)(A) (2012) ("The [SEC] on an ongoing basis shall review each security-based swap . . . to make a determination that such security-based swap . . . should be required to be cleared.").

¹⁰ See generally Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44,464 (July 26, 2011) (to be codified at 17 C.F.R. pts. 39, 140). Top-down review refers to the agency's ongoing role reviewing new swap transactions in the market to determine whether they are of a type that should be subject to the clearing requirement. See *infra* Section II.C.2.

¹¹ See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,315–16 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39, 50) ("[P]roposed § 50.4 set forth the classes of interest rate swaps and CDS that the [CFTC] proposed for required clearing. . . . [T]he [CFTC] is adopting § 50.4(a) and (b).").

¹² See Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps, 81 Fed. Reg. 71,202, 71,226 (Oct. 14, 2016) (to be codified at 17 C.F.R. pt. 50) (expanding the central clearing obligation to additional classes of interest rate swaps).

Through these rules, the CFTC subjected a significant portion of the swaps market to a central clearing requirement.¹³

By contrast, the SEC—operating under identical authorizing statutory language as the CFTC—has not yet made any determinations regarding which security-based swaps will be covered by Title VII’s central clearing requirement.¹⁴ While the SEC established processes for security-based swap submissions in a 2012 rule (the “SEC Process Rule”),¹⁵ the agency is awaiting finalization of several other related rules before accepting security-based swap submissions or making any determinations.¹⁶ Although the timelines for finalization and effective dates of such

¹³ See *infra* Section III.B.1 (noting that, per the statistics provided in the CFTC’s releases, the Initial CFTC Clearing Mandate and Additional CFTC Clearing Mandate together cover a majority of the swap market).

¹⁴ See *infra* Section II.D.2 (discussing the SEC’s regulatory actions taken so far). For a comparison of the SEC and CFTC’s regulatory approaches, see *infra* Figure 2.

¹⁵ See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,605 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249) (“[T]he [SEC] is adopting amendments . . . to establish processes for . . . how clearing agencies registered with the [SEC] must submit Security-Based Swap Submissions to the [SEC] for a determination by the [SEC] of whether the security-based swap . . . referenced in the submission is required to be cleared[.]”).

¹⁶ See Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg. 35,625, 35,635 (June 14, 2012) (to be codified at 17 C.F.R. pt. 240) (“[G]iven the dependency of the [security-based] swap mandatory clearing regime upon other Title VII final rules yet to be adopted, the [SEC] believes [security-based] swaps should not be required to be cleared until after the later of: (1) The compliance date of certain of the final rules resulting from the Clearing Agency Standards Proposing Release; (2) the compliance date of final rules resulting from the End-User Clearing Exception Proposing Release; and (3) the Commission determining whether to propose amendments to the existing net capital and customer protection requirements applicable to broker-dealers . . . and whether to address portfolio margining with swaps.”).

rulemakings remain unclear, the SEC's guidance indicates that submissions will begin once these preliminary rules take effect.¹⁷

However, the SEC has provided no further guidance on whether commission-initiated review will take place or the procedures the SEC will follow in conducting such review.¹⁸ This lack of interest in top-down review for uncleared products will undercut the effectiveness of the central clearing requirement for security-based swaps. While the CFTC's mandatory clearing determinations have not displayed why commission-initiated review is necessary (so far, the CFTC has relied only on submissions from central clearinghouses), the submission-only approach successfully implemented the statutory mandate because swaps were already widely cleared voluntarily prior to the central clearing mandate's implementation.¹⁹ Currently, a far smaller proportion of the security-based swap market is voluntarily cleared, meaning submissions will fail to cover most of the security-based swap market already in existence.²⁰ Further, in contrast with the SEC, the CFTC established the processes for top-down review in the CFTC Process Rule, even though these processes have not yet been used.²¹ By providing clear standards for top-down

¹⁷ *Id.*

¹⁸ *See infra* Section II.D.2 (discussing the SEC's very limited preparation and discussion of commission-initiated review).

¹⁹ *See infra* Section III.B.1 (showing swaps were significantly cleared voluntarily when the CFTC's mandatory clearing requirement took effect).

²⁰ *Semiannual OTC Derivatives Statistics, Global OTC Derivatives Market: Commodity Contracts, Credit Default Swaps*, BANK FOR INT'L SETTLEMENTS, http://stats.bis.org/statx/srs/tseries/OTC_DERIV/H:N:A:Y:R:A:A:5A:5J?t=D5.2&p=20171&i=28.4&x=OD_CPARTY.5.CL_OD_CPARTY&o=s:line,z:3 [perma.cc/S2JW-3JNS] (showing number of Index CDS trades with central clearing parties); *Semiannual OTC Derivatives Statistics, Global OTC Derivatives Market: Commodity Contracts, Credit Default Swaps*, BANK FOR INT'L SETTLEMENTS, http://stats.bis.org/statx/srs/tseries/OTC_DERIV/H:N:D:Y:N:A:A:5A:5J?t=D5.2&p=20171&i=26.8&x=OD_CPARTY.5.CL_OD_CPARTY&o=s:line,z:3 [perma.cc/X8VS-QBSK] (showing number of single-name CDS trades with central clearing parties).

²¹ *See* Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44,464, 44,469 (July 26, 2011) (to be codified at 17 C.F.R. pts. 39, 50) ("Section 723(a)(3) of the Dodd-Frank Act and Regulation 39.5(c) require the

review, the CFTC informed the market that even uncleared swaps *could* be reviewed, incentivizing industry members to pursue voluntary clearing for any swap products that are currently uncleared.²² In the security-based swap context, without any indication that the SEC will conduct commission-initiated review in the future, there is little regulatory impetus for firms to begin voluntary clearing. Accordingly, not only are most products under the SEC's jurisdiction currently unreviewable under the expected submission-only process, they will likely remain outside the scope of the SEC's oversight.

Because the SEC's approach fails to fulfill Title VII's intentions and directives, the agency is violating Dodd-Frank's statutory mandate. Although compelling agency action through litigation can be difficult, the Supreme Court set forth a blueprint for doing so in *Massachusetts v. Environmental Protection Agency*.²³ This case's playbook for challenging an agency's failure to regulate despite a statutory obligation to do so may provide one solution to the SEC's inaction, especially in light of the agency's lack of explanation for its refusal to regulate. However, parties seeking to vindicate a general injury to the economy may not have standing to sue the SEC. Instead, the ability to litigate may be limited to the potentially regulated parties, who may have limited incentives to prompt such regulation. Finding a party both able and willing to bring a suit may, therefore, be difficult. Alternately, reformers could pursue political routes, such as encouraging closer congressional oversight of Dodd-Frank's implementation to put pressure on the SEC.

In Part II, this Note describes Dodd-Frank's regulatory structure and the disparate approaches to implementation taken by the CFTC and the SEC (together, the "Financial

Commission, on an ongoing basis, to review swaps that have not been accepted for clearing by a [derivatives clearing organization] to make a determination as to whether the swaps should be required to be cleared.").

²² See *infra* Section III.B.3 (discussing the role of regulatory incentives in prompting voluntary clearing).

²³ See generally *Massachusetts v. Env'tl. Prot. Agency*, 549 U.S. 497 (2007).

Regulators”). Part III examines the impact of the SEC’s approach on the efficacy of Dodd-Frank’s goal of mandatory central clearing. Finally, Part IV argues that the flaws in the SEC’s implementation of mandatory central clearing should be addressed through litigation or increased political oversight.

II. CONGRESS’ RESPONSE TO OTC DERIVATIVES’ ROLE IN THE FINANCIAL CRISIS: DODD-FRANK’S CENTRAL CLEARING MANDATE

In 2010, Dodd-Frank effected sweeping reforms of the financial industry to protect the United States and global markets from a repeat of the 2008 financial crisis.²⁴ In response to the destabilizing impact of institutional failures leading up to and during the crisis, Dodd-Frank intended “to promote the financial stability of the United States by improving accountability and transparency in the financial system[.]”²⁵ In order to achieve these goals and address the variety of problems exposed by the 2008 collapse, Dodd-Frank’s drafters enlisted the help of experts at a number of financial agencies by delegating a diverse set of regulatory mandates.²⁶

A. OTC Derivatives: What is a Swap?

To fully understand Dodd Frank’s delegation strategy and mandate in the derivatives context, a basic understanding of swaps and their role in the financial crisis is necessary. Following the crisis, one of Congress’ driving concerns was the systemic risk presented by the OTC derivatives market.²⁷

²⁴ See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203, 124 Stat. 1376 (2010).

²⁵ *Id.* at 1376.

²⁶ See Wall Street Transparency and Accountability Act of 2010, Pub. L. No. 111–203 § 712(a)(1)–(2), 124 Stat. 1376, 1641–42 (2010) (requiring the CFTC and SEC consult and coordinate with one another “before commencing any rulemaking or issuing an order” relating to Title VII).

²⁷ See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,284–85 (Dec. 13, 2012) (to be codified at 17

This market includes a variety of financial products, but for the purposes of this Note, the basic mechanics of a swap can best be illustrated through the example of a credit default swap (“CDS”).²⁸ A CDS allows a creditor (the CDS buyer) to transfer the credit risk of debt she holds to another party (the CDS seller) in exchange for a premium.²⁹ If the debtor on the original loan defaults, the CDS buyer transfers the debt securities to the CDS seller, who pays the notional amount of the debt in return.³⁰ The premium that the CDS buyer pays amounts to the CDS seller’s fee for taking on the risk. In exchange, the CDS buyer avoids the risk of significant losses on the underlying debt in the event of default. In bespoke, bilaterally-negotiated CDSs, parties can specify additional credit events or payment amounts, tailoring the product to their individual needs and risk profiles.³¹

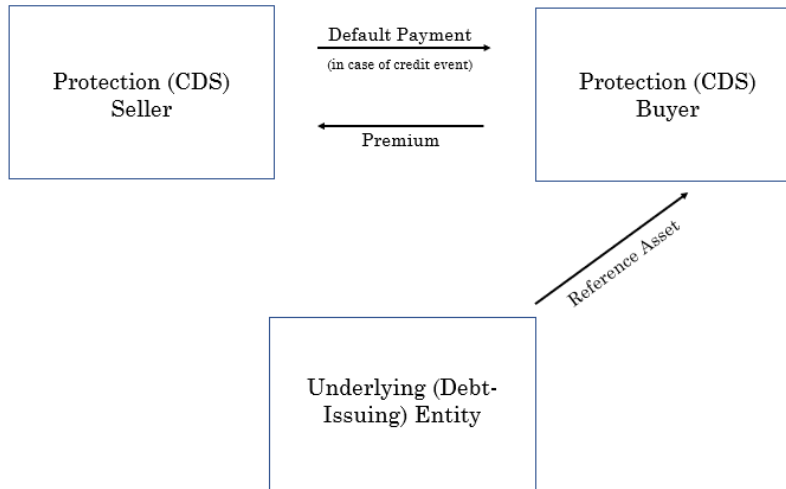
C.F.R. pts. 39, 50) (“The financial crisis also illustrated the significant risks that an uncleared, over-the-counter (OTC) derivatives market can pose to the financial system. . . . Recognizing the peril that the U.S. financial system faced during the financial crisis, Congress and the President came together to pass the Dodd-Frank Act in 2010.”); *see also id.* at xvi (“When the bubble burst, hundreds of billions of dollars in losses in mortgages and mortgage-related securities shook markets as well as financial institutions that had significant exposures to those mortgages and had borrowed heavily against them. This happened not just in the United States but around the world. The losses were magnified by derivatives such as synthetic securities.”). For a broader discussion of the impact of derivatives on the financial crisis, *see generally* the FIN. CRISIS INQUIRY REPORT, *supra* note 1.

²⁸ *See infra* Figure 1. Although other types of swaps played significant roles in exacerbating the financial crisis, a bilateral CDS is used here for the sake of simplicity in the example. The basic concepts of the bilateral CDS are useful in understanding the mechanics of swaps in general and can be applied by analogy to other types of swaps.

²⁹ *See* Chander & Costa, *supra* note 2, at 642.

³⁰ *Id.* at 642–43.

³¹ *Id.* Additional credit events are particularly useful to allow insurance from credit issues other than bankruptcy or a simple failure to pay back the loan. Typical ones include public repudiation of the debt (i.e. announcing an intention not to pay), acceleration of the debt, or a government intervention. *See* INT’L SWAPS & DERIVATIVES ASS’N, 2014 ISDA CREDIT DERIVATIVE DEFINITIONS art. IV (2014) (listing and providing standard language for a variety of different occurrences that can be included, at the parties’ election, as credit events).

Figure 1: Mechanics of a CDS Transaction

Although the type of underlying security and payment flows change depending on the product type, other classes of OTC derivatives operate in a similar manner. Broadly, swaps allow financial institutions and investors to trade out of a position or gain exposure to specific types of risk as an investment strategy.³² For many products, one party to the trade agrees to take on the unpredictability (but potential profitability) of an underlying security's returns, and in exchange, provides their counterparty with a more dependable payment or premium.³³ In other instances, both

³² See Andreas A. Jobst, *A Primer on Structured Finance*, 13 J. DERIVATIVES & HEDGE FUNDS 199, 202–03 (2007).

³³ See *id.* This arrangement allows investors to gain exposure to types of risk to which they may not otherwise have access. For example, risk-neutral swap dealers use their access to certain product types or markets (whether accessible because of the dealers' location, relationship with foreign governments, or access to capital) to generate consistent revenue streams (the swap fee), while end-user investors pay the fee to invest in their desired risk-profile. John D. Finnerty & Kishlaya Pathak, *A Review of Recent Derivatives Litigation*, 16 FORDHAM J. CORP. & FIN. L. 73, 84 (2011). The bespoke nature of swaps lets parties adapt the transaction to their individual risk profiles—i.e., the swap seller can retain more of the risk, in

sides receive variable future returns rather than a consistent benchmark payment, effectively trading one type of risk for another.³⁴ In all of these examples, the bespoke nature of the transaction allows parties to adapt the terms and mechanics, tweaking or creating products as needed to suit the individual risk portfolios and appetites of each participant.³⁵

As a result, the OTC derivatives market is variable and adaptive, with as many distinct swap products as parties with unique needs and creative solutions. The market is also of notable size. The Bank for International Settlements pegged the notional amount of outstanding OTC derivatives contracts at \$542 trillion at the end of June 2017.³⁶ The gross market

exchange for a higher fee—simply by adjusting the mechanics laid out in the contract. Investors can also use swaps as a form of financing, in which they receive an investment's returns without needing to buy the underlying security, which will be held—again, for a fee—by the dealer. *Id.*

³⁴ See, e.g., *id.* at 84–85; Caitlin Hall, *The Death of a Defense: How Derivatives Spell the End of the Good Faith Defense to Fraudulent Transfer Actions in Business Bankruptcies*, 8 BERKELEY BUS. L.J. 152, 165 (2011) (“A total return swap is an agreement under which one party makes periodic interest payments and the other makes payments based on the return of an underlying asset.”). In addition to operating as a transaction where one side is seeking to be risk neutral, see *supra* note 33 and accompanying text, these transactions can also involve parties who are both interested in taking on different types of risk that are currently held by the other side (for instance, the risk of an underlier in exchange for the risk of an interest benchmark)—in other words, a “swap” of risk profiles.

³⁵ See Finnerty & Pathak, *supra* note 33, at 85 (“A clever derivatives trader can use different derivative instruments almost interchangeably to achieve any particular payoff pattern.”). This adaptability is a central feature of swaps when they are used for hedging purposes. Parties interested in hedging the risk of their investments can (and often do) enter into derivatives to do so. For this hedging to be effective, though, the investor must tailor the derivative contract to mimic the terms of the underlying asset—any difference in terms will undermine the hedge's effectiveness. For instance, if a CDS buyer fails to align the CDS's payment timing with that of the underlying debt, the gap will cause the buyer to take on the risk of currency or market movements in the interim, limiting the success of their insurance. Swaps' flexibility allows investors to retain some risk in this manner intentionally, but where the investor intends their hedges to be perfect, an off-the-shelf product would fail.

³⁶ BANK FOR INT'L SETTLEMENTS, STATISTICAL RELEASE: OTC DERIVATIVES STATISTICS AT END-JUNE 2017 2 (Nov. 2, 2017),

value of outstanding OTC derivatives contracts was \$13 trillion as of the same time.³⁷ OTC derivatives currently occupy a significant portion of financial markets, and their role was even greater prior to the financial crisis.³⁸ This underscores the potential these products have to meaningfully impact the global economy.

B. The Role of OTC Derivatives in the Financial Crisis

According to the Financial Crisis Inquiry Commission, created to examine the 2008 financial crisis's causes,³⁹ OTC derivatives played a significant role in the 2008 collapse.⁴⁰ In the years preceding the crisis, the OTC derivatives market expanded rapidly, peaking at an outstanding notional amount of \$672.6 trillion in June 2008.⁴¹ This expansion largely occurred following the adoption of the Commodity Futures

https://www.bis.org/publ/otc_hy1711.pdf [<https://perma.cc/92DN-6CVJ>]. "Notional amount" refers to the theoretical value of the trade's underlying security. See *Definition of Notional Value*, FIN. TIMES, <http://lexicon.ft.com/Term?term=notional-value> [<https://perma.cc/U85T-RA38>]. For instance, in a CDS trade where the CDS buyer is purchasing protection for the credit risk of a \$1 million loan, the notional amount of the CDS is \$1 million.

³⁷ *Id.* Gross market value refers to the value of the actual product, i.e. the fee it costs to purchase the derivative. See *Glossary, Gross Market Value*, BANK FOR INT'L SETTLEMENTS, <https://www.bis.org/statistics/glossary.htm?&selection=312&scope=Statistics&c=a&base=term> [<https://perma.cc/8LTR-MLHN>] ("Sum of the absolute values of all outstanding derivatives contracts with either positive or negative replacement values evaluated at market prices prevailing on the reporting date.").

³⁸ See *infra* Section II.B.

³⁹ See FIN. CRISIS INQUIRY REPORT, *supra* note 1, at xi.

⁴⁰ *Id.* at xxiv ("We conclude over-the-counter derivatives contributed significantly to this crisis."). By 2008, "outstanding OTC derivatives [had] increased more than sevenfold to a notional amount of \$672.6 trillion; their gross market value was \$20.3 trillion." *Id.* In particular, former-U.S. treasury secretary Lawrence Summers noted that "the derivatives that proved to be by far the most serious, those associated with credit default swaps, increased 100 fold between 2000 and 2008." *Id.* at 49 (internal citation omitted).

⁴¹ *Id.* at 48 (noting also that the gross market value of outstanding OTC derivatives was \$20.3 trillion).

Modernization Act of 2000,⁴² which deregulated the OTC derivatives market.⁴³ While many institutions used OTC derivatives to hedge risk, these derivatives' unregulated status prior to the financial crisis also made them a cost-effective investment strategy. As a result, OTC derivatives often served as a mechanism to increase leverage.⁴⁴

This widespread use of OTC derivatives had two important consequences for the financial crisis' depth and breadth. First, the lack of regulation allowed for increased leverage, leading to significant derivative positions.⁴⁵ These large positions included significant stakes in CDSs, which were often used to insure the credit risk of mortgage-backed securities and collateralized debt obligations.⁴⁶ As a result, the housing crisis of 2007—and the associated rise in mortgage defaults—

⁴² Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000).

⁴³ See FINANCIAL CRISIS INQUIRY REPORT, *supra* note 1, at 48 (noting that the Commodity Futures Modernization Act of 2000 ("CFMA") "in essence deregulated the OTC derivatives market and eliminated oversight by both the CFTC and the SEC."). While the CFMA allowed the SEC to retain anti-fraud jurisdiction over securities-based OTC derivatives, the law broadly excluded various types of swap agreements and other OTC derivatives from regulation under the Commodities Exchange Act ("CEA"). See *id.*; see also Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 §§ 102–107 (2000) (excluding a variety of product types including derivative and swap transactions from the scope of the CEA and expressly stating that "[n]o provision of [the CEA] shall be construed as implying or creating any presumption that [any transaction or agreement excluded or exempted from the CEA] is or would otherwise be subject to [the CEA].").

⁴⁴ FIN. CRISIS INQUIRY REPORT, *supra* note 1, at 49 ("These international capital standards accommodated the shift to increased leverage. . . . OTC derivatives let derivatives traders—including the large banks and investment banks—increase their leverage."). Mechanically, derivatives allowed for such an increase in leverage because they allowed for the swap-holder to maintain significantly lower capital reserves, limiting the necessity of up-front costs paid by the investor. The amount of collateral the investor provides during the life of the swap is significantly lower than the initial outlay of purchasing the underlying security itself. *Id.*

⁴⁵ *Id.* at xix–xx.

⁴⁶ *Id.* at 50 ("A key OTC derivative in the financial crisis was the credit default swap[.]").

spread to the many financial institutions trading in the CDS market.⁴⁷

Second, the lack of transparency in the OTC derivatives market obscured the size of these positions from counterparties and regulators.⁴⁸ As entities increased their leverage, any decline in the value of the underlying assets could place the trading entities in financial turmoil.⁴⁹ The growth of the general OTC derivatives market connected financial institutions to one another, increasing the possibility that a loss in value or instability could result in a chain reaction of uncertainty and banking runs.⁵⁰ This heightened exposure thus subjected trading counterparties to increased credit risk, but without insight into the other side's position, neither counterparties nor central regulators could gauge the true extent of the systemic risk.⁵¹ As the crisis deepened, this opacity exacerbated fears that any trading partner could be the next to fail, resulting in dramatic losses for all counterparties. This uncertainty created a vicious cycle in which doubt between trading partners contracted liquidity in OTC derivatives and further destabilized the already-buckling markets.⁵²

⁴⁷ *See id.* at 213 (“Much of the risk from mortgage-backed securities had actually been taken by a small group of systemically important companies with outsized holdings These companies would ultimately bear great losses[.]”).

⁴⁸ *Id.* at 386 (“Lack of transparency contributed greatly to the crisis: the exposures of financial institutions to risky mortgage assets and other potential losses were unknown to market participants, and indeed many firms did not know their own exposures.”).

⁴⁹ *See id.* at xix–xx.

⁵⁰ *See id.* at xx (“Massive, short-term borrowing, combined with obligations unseen by others in the market, heightened the chances the system could rapidly unravel.”).

⁵¹ *See id.* at 363–64 (“This market was unregulated and largely opaque, with no public reporting requirements and little or no price discovery.”).

⁵² *Id.* at 363–64, 386; *see also* Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,285 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39, 50) (“As the financial crisis deepened, this risk made market participants wary of trading with each other. As a result, markets quickly became illiquid and trading volumes plummeted.”).

C. Congress' Response: The Wall Street Transparency and Accountability Act

The financial crisis brought the systemic risk in the OTC derivatives market into the light. Afterwards, policymakers understood that the unregulated OTC derivatives market needed “a comprehensive new regulatory framework[.]”⁵³ The Senate specified that, in drafting Dodd-Frank, it intended to promulgate “comprehensive regulation and rules for how the OTC derivatives market operates.”⁵⁴ This objective was met in Title VII of Dodd-Frank, also known as The Wall Street Transparency and Accountability Act of 2010.⁵⁵

1. Title VII's Core: Mandatory Central Clearing as a Means of Risk-Prevention

Title VII's centerpiece is the requirement that parties clear their trades through central clearinghouses. Under the statute, this requirement does not attach to a specific product type until the Financial Regulators determine that it must be centrally cleared.⁵⁶ However, while the Financial Regulators may determine that some OTC derivatives should remain uncleared (and instead be subject to heightened capital, margin, and reporting requirements), the Senate report stated a clear preference for mandatory central clearing in the absence of mitigating circumstances.⁵⁷ The report acknowledged that “[s]ome parts of the OTC market may not

⁵³ Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. at 74,285.

⁵⁴ S. REP. NO. 111-176, at 32 (2010).

⁵⁵ Wall Street Transparency and Accountability Act of 2010, Pub. L. No. 111-203 §§ 701, 711-54, 761-74, 124 Stat. 1376, 1641-1802 (2010).

⁵⁶ See 7 U.S.C. § 2(h)(1)(A) (2012) (“It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization . . . *if the swap is required to be cleared.*”) (emphasis added); 15 U.S.C. § 78c-3(a)(1) (2012) (“It shall be unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a clearing agency . . . *if the security-based swap is required to be cleared.*”) (emphasis added).

⁵⁷ See S. REP. NO. 111-176, at 31-35.

be suitable for clearing . . . due to individual business needs,” but maintained that “[t]hese exceptions should be crafted very narrowly[.]”⁵⁸ The Financial Regulators interpreted Title VII accordingly: the CFTC referred to the central clearing requirement as “one of the cornerstones of [Dodd-Frank] reform,”⁵⁹ while the SEC noted that “[c]learing of swaps and security-based swaps was at the heart of Congressional reform of the derivatives markets[.]”⁶⁰

Although Congress asked the Financial Regulators to fill in the details, Title VII lays out a general structure for agencies to follow when making central clearing determinations.⁶¹ The CFTC and SEC regulate different product types (swaps and security-based swaps, respectively),⁶² but the statutory language is otherwise identical.⁶³ For both product types, Title VII includes two

⁵⁸ *Id.* at 34.

⁵⁹ Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,285 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39, 50).

⁶⁰ *See* Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,603 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249).

⁶¹ Wall Street Transparency and Accountability Act of 2010, Pub. L. No. 111–203 §§ 701, 711–54, 761–74, 124 Stat. 1376, 1641–1802 (2010).

⁶² *See* Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. at 41,603 (“Title VII provides that the CFTC will regulate ‘swaps,’ [and] the [SEC] will regulate ‘security-based swaps[.]’”). The statute defines swaps as “any agreement, contract, or transaction” that is one of a broad variety of derivatives. 7 U.S.C. § 1a(47). A security-based swap is a swap that is based on “a narrow-based security index . . . a single security or loan . . . or . . . the occurrence, nonoccurrence, or extent of the occurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index[.]” 15 U.S.C. § 78c(a)(68).

⁶³ *Compare* 7 U.S.C. § 2(h)(1)(A) (2012) (“It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organization that is registered under this chapter or a derivatives clearing organization that is exempt from

separate review processes: the agencies will conduct “[c]ommission-initiated review”⁶⁴ and accept submissions⁶⁵ to determine which products will be subject to the clearing requirement. Once the Financial Regulators determine, pursuant to this process, that a product must be cleared, it is unlawful to engage in a swap or security-based swap without central clearing.⁶⁶

Under the submission process, clearing agencies that plan to accept swaps or security-based swaps for clearing submit these swaps or security-based swaps to the Financial Regulators.⁶⁷ Commission-initiated review directs the Financial Regulators to supplement these submissions with evaluations of those OTC derivatives that are not accepted for clearing anywhere—the part of the market made up of “privately negotiated transactions entered into by two

registration under this chapter if the swap is required to be cleared.”) *with* 15 U.S.C. § 78c-3(a)(1) (2012) (“It shall be unlawful for any person to engage in a security-based swap unless that person submits such security-based swap for clearing to a clearing agency that is registered under this chapter or a clearing agency that is exempt from registration under this chapter if the security-based swap is required to be cleared.”).

⁶⁴ See 7 U.S.C. § 2(h)(2)(A)(i) (2012) (“The [CFTC] on an ongoing basis shall review each swap . . . to make a determination as to whether the swap . . . should be required to be cleared.”); 15 U.S.C. § 78c-3(b)(1)(A) (2012) (“The [SEC] on an ongoing basis shall review each security-based swap . . . to make a determination that such security-based swap . . . should be required to be cleared.”).

⁶⁵ See 7 U.S.C. § 2(h)(2)(B)(i) (2012) (“A derivatives clearing organization shall submit to the [CFTC] each swap . . . that it plans to accept for clearing[.]”); 15 U.S.C. § 78c-3(b)(2)(A) (2012) (“A clearing agency shall submit to the [SEC] each security-based swap . . . that it plans to accept for clearing[.]”).

⁶⁶ See 7 U.S.C. § 2(h)(1)(A) (2012) (“It shall be unlawful for any person to engage in a swap . . . if the swap is required to be cleared.”); 15 U.S.C. § 78c-3(a)(1) (2012) (“It shall be unlawful for any person to engage in a security-based swap . . . if the security-based swap is required to be cleared.”).

⁶⁷ See 7 U.S.C. § 2(h)(2)(B)(i) (2012) (“A derivatives clearing organization shall submit to the [CFTC] each swap . . . that it plans to accept for clearing[.]”); 15 U.S.C. § 78c-3(b)(2)(A) (2012) (“A clearing agency shall submit to the [SEC] each security-based swap . . . that it plans to accept for clearing[.]”).

counterparties, in which each assumes the credit risk of the other[.]”⁶⁸ When making determinations under either approach, the statute requires that the Financial Regulators consider five factors: (1) economic characteristics of the product, such as outstanding notional exposure, trading liquidity, and adequate pricing data; (2) operational viability of clearing the contracts consistently with their current material terms and trading conventions; (3) the extent to which mandatory clearing will mitigate systemic risk; (4) impact of mandatory clearing on competition; and (5) the existence of “reasonable legal certainty” with regard to treatment of customer positions, funds, and property in the event of a clearing organization or member’s insolvency.⁶⁹

The statute further emphasizes the importance of central clearing by authorizing the Financial Regulators to prescribe rules that “prevent evasions of the mandatory clearing requirements[.]”⁷⁰ Where a product type should be subject to mandatory clearing, but there is no eligible organization listing the product, the Financial Regulators are allowed to instead mitigate the risk by requiring that parties retain additional margin or capital.⁷¹ These fallback requirements are meant to serve dual purposes: protecting parties from credit risk and encouraging the market to consider centrally clearing products that it may not have otherwise.

In summary, the statutory structure reflects the Senate’s policy preference for mandatory central clearing. Title VII’s primary means of regulation—the mandatory clearing determinations and the two procedures set out for reviewing product types (by submission process and commission-initiated review)—ensure that the Financial Regulators will consider all derivative products for mandatory clearing. The

⁶⁸ Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,603 (July 13, 2012) (codified at 17 C.F.R. pts. 240, 249).

⁶⁹ See 7 U.S.C. § 2(h)(2)(D)(ii) (2012); 15 U.S.C. § 78c-3(b)(4)(B) (2012).

⁷⁰ See 7 U.S.C. § 2(h)(4)(A) (2012); 15 U.S.C. § 78c-3(d)(1) (2012).

⁷¹ See 7 U.S.C. § 2(h)(4)(B)(iii) (2012); 15 U.S.C. § 78c-3(d)(2)(C) (2012).

fallback regulatory options of increased margin and capital requirements are included to address the risk presented by products that are not suitable for central clearing, but the increased costs also intend to prod the market toward standardization and clearing where possible.

2. International Consensus on Mandatory Central Clearing

The Title VII approach is similar to policy decisions made concurrently in the international financial community. In 2009, the Group of Twenty (“G20”)⁷² agreed to clear all standardized OTC derivatives and attach higher capital requirements to those that remained uncleared.⁷³ The Financial Stability Board, an international financial monitoring organization, affirmed the international undertaking in its October 2010 report on Implementing OTC Derivatives Market Reforms, and the G20 reiterated its goal at a November 2011 summit.⁷⁴ A February 2012 report from the International Organization of Securities Commissions (“IOSCO”) followed, recommending specific policy approaches that would help achieve the goals of mandatory central clearing.⁷⁵ G20 members then began implementing such

⁷² The G20 is an international organization that provides a forum for the largest advanced and emerging economies to meet and discuss financial regulation and the global economy. See Grp. of Twenty, *About G20*, G20.ORG, <http://g20.org.tr/about-g20/> [perma.cc/L3JP-2HF8]. The G20 members are Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the European Union. Grp. of Twenty, *G20 Members*, G20.ORG, <http://g20.org.tr/about-g20/g20-members/> [perma.cc/4Y55-4E5D].

⁷³ See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,286 (Dec. 13, 2012) (codified at 17 C.F.R. pts. 39, 50).

⁷⁴ See *id.* See generally FIN. STABILITY BD., IMPLEMENTING OTC DERIVATIVES MARKET REFORMS (Oct. 25, 2010), http://www.fsb.org/wp-content/uploads/r_101025.pdf [perma.cc/WL2H-Z4PZ].

⁷⁵ See TECH. COMM. OF THE INT’L ORG. OF SEC. COMM’NS, REQUIREMENTS FOR MANDATORY CLEARING (Feb. 2012) [hereinafter IOSCO REPORT].

regulations.⁷⁶ The Senate expressly considered the international consensus while developing Title VII's framework.⁷⁷ In discussing the clearing requirement's centrality to the regulatory framework, the Senate report even quoted a G20 steering group letter: "[s]tandardized over-the-counter derivatives contracts should be . . . where appropriate, cleared through central clearing counterparties by 2012 at the latest[.]"⁷⁸ Accordingly, this international context should inform any interpretation of the goals and intent of Title VII's statutory and regulatory scheme.

The IOSCO report asks "whether a mandatory clearing obligation should apply to a [given] product or set of products" as the threshold question in a mandatory clearing regime.⁷⁹ In making this determination, IOSCO recommended that authorities utilize both a "bottom-up approach," which determines mandatory clearing obligations for products proposed for clearing by a central clearinghouse, and a "top-down approach," under which the regulator examines products that central clearinghouses are not currently clearing or seeking to clear.⁸⁰

For several reasons, the bottom-up approach is useful as a starting point.⁸¹ As central clearinghouses identify new products they wish to clear, their applications for authorization to clear these products initiates review for a mandatory clearing determination.⁸² Bottom-up review also jump-starts the process by focusing central regulators' initial attention on products for which voluntary central clearing is already a commercial option. If some market participants choose not to voluntarily centrally clear, these submissions (and subsequent determinations) will quickly reduce the

⁷⁶ See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. at 74,286.

⁷⁷ S. REP. No. 111-176, at 32 (2010).

⁷⁸ *Id.* (internal citation omitted).

⁷⁹ IOSCO REPORT, *supra* note 75, at 5.

⁸⁰ *Id.*

⁸¹ See *id.* at 13.

⁸² *Id.* at 12.

number of uncleared trades by establishing an obligation to do so.

Top-down review remains necessary alongside the submission process, though, because without it, there is no review of OTC derivatives that no clearinghouse seeks to clear. Absent such review, the market—rather than central regulators—will choose when submissions are made and will therefore determine which products are potentially subject to the central clearing mandate.⁸³ Further, a system without top-down review would limit agencies' ability to review new products as they emerge in the market, instead leaving the agency to wait for a central clearinghouse that wishes to clear (and therefore initiate review).⁸⁴ By utilizing both processes—IOSCO's recommended approach—regulators instead review the entire OTC derivatives market, ensuring they can flexibly account for the “continuing and dynamic evolution of the range of products[.]”⁸⁵

As discussed in Part II.C.1 above, Title VII establishes a regulatory framework aligned with these IOSCO recommendations. The submission processes are the bottom-up approach, which is supplemented by the top-down commission-initiated review. In this manner, Congress' choices reflect an understanding of the international consensus regarding both methods' importance.

D. The Financial Regulators' Implementation of The

⁸³ *See id.* at 24 (“Under the top-down approach, a determining authority identifies products that it deems may be suitable for mandatory clearing based on the criteria within its jurisdiction even though there may be no [central clearing party] clearing or seeking to clear that particular product.”).

⁸⁴ *See id.* at 11 (“As new OTC derivative products emerge or existing products and [central clearing party] coverage of existing products change, products may be determined to be subject to a mandatory clearing obligation as deemed appropriate by the determining authority. This enables authorities to respond to developments in the OTC derivatives markets and to adapt mandatory clearing obligations accordingly.”).

⁸⁵ *Id.*

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Despite identical statutory language, the CFTC and SEC approached implementation in dramatically different manners.⁸⁶ The CFTC promulgated rules governing the submission process and commission-initiated review in 2011.⁸⁷ In 2012, it used these processes to determine that certain classes of interest-rate swaps and CDSs would be subject to the central clearing requirement.⁸⁸ Ongoing CFTC review since 2012 supplemented these initial determinations and added to the mandatory clearing rules accordingly.⁸⁹

The SEC has taken “a slower, more deliberate approach to rulemaking.”⁹⁰ In 2011, the SEC issued an Exemptive Order granting private actors temporary relief from compliance with certain provisions until the SEC was able to produce its regulations.⁹¹ In 2012, an SEC timeline for the promulgation of final rules under Dodd-Frank regulating security-based swaps noted that a proposed rule had already set forth the expected submission process for security-based swaps.⁹² This

⁸⁶ See *infra* Figure 2.

⁸⁷ See *generally* Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44,464 (July 26, 2011) (to be codified at 17 C.F.R. pts. 39, 140).

⁸⁸ See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,287 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39, 50) (using submissions from clearing organizations to establish the central clearing mandate).

⁸⁹ See Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps, 81 Fed. Reg. 71,202, 71,226 (Oct. 14, 2016) (codified at 17 C.F.R. pt. 50) (expanding the central clearing obligation to additional classes of interest rate swaps).

⁹⁰ Julian E. Hammar, David B. Lichtstein & Robert J. Dilworth, *The SEC's Long-Awaited Security-Based Swaps Rules May Be Approaching*, 50 REV. SEC. & COMMODITIES REG. 77, 78 (2017).

⁹¹ See *generally* Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, 76 Fed. Reg. 36,287 (June 22, 2011) (to be codified at 17 C.F.R. pt. 240).

⁹² See Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg.

rule was finalized a month later,⁹³ but the earlier timeline also clarified that submissions and determinations would not begin until other necessary rules were also finalized.⁹⁴ As of this publication, the SEC has neither begun submissions of security-based swaps for review nor determined that any products must be centrally cleared.⁹⁵

1. The CFTC Takes Action

Title VII grants the CFTC jurisdiction over swaps, a subset of OTC derivatives estimated to make up approximately ninety percent of the market.⁹⁶ This significant portion of OTC derivatives includes CDSs on broad-based security indices, one of the classes of OTC derivatives which prominently impacted the market during the 2008 financial crisis.⁹⁷ Due to the scope of the CFTC's responsibility,

35,625, 35,626 (June 14, 2012) (to be codified at 17 C.F.R. pt. 240) (“[T]he [SEC] . . . has proposed . . . [r]ules relating to mandatory clearing of [security-based] swaps that would specify the process for a registered clearing agency’s submission for review of [security-based] swaps that the clearing agency plans to accept for clearing[.]”).

⁹³ See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602 (July 13, 2012).

⁹⁴ See Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg. at 35,634–36.

⁹⁵ See Hammar et al., *supra* note 90, at 77; see also Joanna Wright, *SEC Finally Moves Forward on Single-Name CDS Dealer Rules*, RISK.NET (Oct. 8, 2018), <https://www.risk.net/regulation/6007591/sec-finally-moves-forward-on-single-name-cds-dealer-rules> [<https://perma.cc/3C8C-WW5N>] (noting that while the SEC is working towards finalization of other Title VII rules, Commissioner Hester Peirce, when asked about “a rule for mandatory clearing of single-name credit-default swap products, Pierce said only that the SEC has not yet proposed such a rule”).

⁹⁶ Hammar et al., *supra* note 90, at 78.

⁹⁷ See Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208, 48,308 (Aug. 13, 2012) (to

including jurisdiction over a product type under a significant amount of political scrutiny, the agency moved quickly to implement its response.⁹⁸

In 2011, the CFTC promulgated the CFTC Process Rule, establishing operational processes for swap submissions and the CFTC's factors for determining whether swaps should be subject to a central clearing requirement.⁹⁹ Under this rule, swap submissions: (1) are made by any derivatives clearing organization that plans to accept the product for clearing; and (2) must include information that will enable the CFTC to evaluate the five Dodd-Frank criteria for mandatory clearing.¹⁰⁰ The CFTC makes each submission publicly available for comment and reviews the submission and comments thereon.¹⁰¹ The CFTC then makes a mandatory clearing determination within ninety days of the submission.¹⁰²

The CFTC Process Rule also provides procedures for top-down review.¹⁰³ Commission-initiated review occurs on an ongoing basis for "swaps that have not been accepted for clearing by a derivatives clearing organization" to determine whether they should be subject to required clearing.¹⁰⁴ This review looks to information acquired from swap data

be codified at 17 C.F.R. pt. 1); CFTC Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,287 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39, 50).

⁹⁸ See Hammar et al., *supra* note 90, at 81.

⁹⁹ See Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44,464 (July 26, 2011) (to be codified at 17 C.F.R. pts. 39, 140).

¹⁰⁰ See 17 C.F.R. § 39.5(b)(3)(ii) (2018) ("The submission . . . shall include . . . [a] statement that includes, but is not limited to, information that will assist the [CFTC] in making a quantitative and qualitative assessment of the following factors"); see also 7 U.S.C. § 2(h)(2)(D)(ii) (2012) (containing the five criteria for review).

¹⁰¹ See *id.* § 39.5(b)(5) ("The submission will be made available to the public and posted on the [CFTC] Web site for a 30-day public comment period.").

¹⁰² See *id.* § 39.5(b)(6) ("The [CFTC] will make its determination not later than 90 days after a complete submission has been received, unless the submitting derivatives clearing organization agrees to an extension.").

¹⁰³ See *id.* § 39.5(c).

¹⁰⁴ See *id.* § 39.5(c)(1).

repositories, swap dealers, and other entities involved in the market.¹⁰⁵ While the rule does not provide any timeframe for review, it requires that any determination made under commission-initiated review be made public and available for comment.¹⁰⁶

After a year and a half, these processes resulted in the Initial CFTC Clearing Mandate.¹⁰⁷ This rule requires central clearing for interest rate swaps and CDSs with certain specifications.¹⁰⁸ Derivative clearinghouses voluntarily cleared these covered products prior to the rule, and, in fact, the CFTC made its determinations based on submissions from derivative clearing organizations currently clearing those swaps.¹⁰⁹ The CFTC chose these classes in part because the new obligation would cover a significant portion of the market, but also “because these swaps [were] currently being cleared,” so the initial requirement would not disrupt the market unnecessarily.¹¹⁰ The agency acknowledged, though, that this rule was only a preliminary step; since “swap clearing is likely to evolve,” later determinations “may be based on a variety of other factors beyond the extent to which the swaps in question are already being cleared.”¹¹¹ As predicted, the later

¹⁰⁵ *Id.*

¹⁰⁶ See Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44,464, 44,469 (July 26, 2011) (to be codified at 17 C.F.R. pts. 39, 140) (“[The CFTC] will make such determinations on a case-by-case basis, after taking into consideration any comments received pursuant to the 30-day public comment period[.]”); 17 C.F.R. § 39.5(c)(2) (2018) (“Notice regarding any determination . . . will be made available to the public and posted on the [CFTC] Web site for a 30-day public comment period.”).

¹⁰⁷ See generally Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39, 50).

¹⁰⁸ See 17 C.F.R. § 50.4 (2018).

¹⁰⁹ See CFTC Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. at 74,287 (“The [CFTC] received submissions relating to CDS and interest rate swaps The clearing requirement determinations and rules adopted in this release cover certain CDS and interest rate swaps currently being cleared by a [derivatives clearing organization].”).

¹¹⁰ *Id.*

¹¹¹ *Id.*

Additional CFTC Clearing Mandate (promulgated in 2016) included swaps submitted by clearing organizations that wished to clear the products, but which were not yet centrally cleared.¹¹²

2. The SEC's Deliberate Approach

Under Title VII, the SEC's jurisdiction covers security-based swaps, which account for most of the ten percent of OTC derivatives not under the CFTC's jurisdiction.¹¹³ Among other product types, security-based swaps include equity swaps and single name CDSs.¹¹⁴ With less of the market share to cover, the SEC understandably approached implementation more slowly than the CFTC. As a result, much of the SEC's Title VII rulemaking currently remains only proposed or is finalized with delayed compliance dates.¹¹⁵

The SEC first produced a timeline for efficient and undisruptive Title VII implementation.¹¹⁶ A rule specifying

¹¹² See Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps, 81 Fed. Reg. 71,202, 71,206 (Oct. 14, 2016) (to be codified at 17 C.F.R. pt. 50).

¹¹³ See Hammar et al., *supra* note 90, at 78. Title VII also envisioned the existence of "mixed swaps," products with criteria that overlap between swaps and security-based swaps and which were subject to joint CFTC and SEC jurisdiction. See 15 U.S.C. § 8302(a)(8) (2012) ("The Commodity Futures Trading Commission and the Securities and Exchange Commission, after consultation with the Board of Governors, shall jointly prescribe such regulations regarding mixed swaps . . . as may be necessary to carry out the purposes of this title."); see also Hammar et al., *supra* note 90, at 78. Accordingly, swaps and security-based swaps together do not amount to one hundred percent of the OTC derivatives market. While the Financial Regulators have promulgated regulations regarding mixed swaps, this joint jurisdiction is beyond the scope of this Note, which focuses specifically on security-based swaps. See generally Regulation of Mixed Swaps, 17 C.F.R. § 240.3a68-4 (2018).

¹¹⁴ Hammar et al., *supra* note 90, at 78.

¹¹⁵ *Id.* at 81–82 (citing, inter alia, *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/spotlight/implementation-of-dodd-frank-act.shtml> [<https://perma.cc/MQ74-UMPK>] (last modified June 21, 2018)).

¹¹⁶ See Statement of General Policy on the Sequencing of the Compliance Dates for Final Rules Applicable to Security-Based Swaps

the submission process for security-based swaps was already proposed,¹¹⁷ and the timeline noted that such a rule could be adopted without any additional prior action.¹¹⁸ However, regardless of whether these procedures were to be established in the near future, security-based swaps would not be mandatorily cleared until after the later of:

- (1) The compliance date of certain of the final rules resulting from the Clearing Agency Standards Proposing Release; (2) the compliance date of final rules resulting from the End-User Clearing Exception Proposing Release; and (3) the [SEC] determining whether to propose amendments to the existing net capital and customer protection requirements applicable to broker-dealers with regard to [security-based] swap clearing through such-broker dealers and whether to address portfolio margining with swaps.¹¹⁹

Six years later, the SEC still has not taken some of these preliminary steps, and as a result, the agency has not begun accepting submissions for mandatory clearing determinations. The Clearing Agency Standards Proposing Release resulted in one final rule on its central topic, but the SEC pushed a number of other rules proposed in the release to a later date, and many are still not finalized.¹²⁰ Similarly,

Adopted Pursuant to the Securities Exchange Act of 1934 and the Dodd-Frank Wall Street Reform and Consumer Protection Act, 77 Fed. Reg. 35,625, 35,627–28 (June 14, 2012) (to be codified at 17 C.F.R. pt. 240) (“[T]he [SEC] seeks to sequence the implementation of the final rules to be adopted pursuant to Title VII of the Dodd-Frank Act in an appropriate manner.”).

¹¹⁷ *Id.* at 35,626 (“[T]he [SEC] . . . has proposed . . . [r]ules relating to mandatory clearing of [security-based] swaps that would specify the process for a registered clearing agency’s submission for review of [security-based] swaps that the clearing agency plans to accept for clearing[.]”).

¹¹⁸ *Id.* at 35,635 (“[T]he [SEC] believes it may be appropriate for the procedural rules related to mandatory clearing determinations to be adopted before the rules further defining the terms ‘swap,’ ‘security-based swap,’ ‘security-based swap agreement,’ and ‘mixed swap’ are adopted and/or effective or before the Cross-Border Rules are proposed.”).

¹¹⁹ *Id.*

¹²⁰ *See* Clearing Agency Standards, 77 Fed. Reg. 66,220, 66,220–23 (Nov. 2, 2012) (to be codified at 17 C.F.R. pt. 240).

while the SEC proposed the End-User Clearing Exception in 2010, it still has not finalized the rule.¹²¹

Although the SEC is not accepting submissions, it finalized the SEC Process Rule (which specifies the mechanism for submissions that would be used) shortly after the timeline's release.¹²² As under the CFTC Process Rule, the SEC Process Rule obligates registered clearing agencies to submit any security-based swap they plan to accept for clearing.¹²³ Each submission must contain certain information to assist the SEC in evaluating the five factors from Title VII.¹²⁴ However, unlike the CFTC, the SEC included no timeframe within which review must be conducted or a determination must be issued.¹²⁵

Further, the SEC's general approach differed from the CFTC's structure significantly: neither the SEC Process Rule—nor any other SEC release—provided insight into the SEC's operation of commission-initiated review.¹²⁶ In the Exemptive Order, the SEC categorizes Title VII's requirement of commission-initiated review as “Authorizes /Directs [SEC] Action,”¹²⁷ correctly indicating that the statutory provision

¹²¹ See End-User Exception to Mandatory Clearing of Security-Based Swaps, 75 Fed. Reg. 79,992 (proposed Dec. 21, 2010) (to be codified at 17 C.F.R. pt. 240).

¹²² See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249).

¹²³ 17 C.F.R. § 240.19b-4(o)(1) (2018).

¹²⁴ See *id.* § 240.19b-4(o)(2)–(3); see also 15 U.S.C. § 78c-3(b)(4)(B) (2012) (containing the five factors to consider in review).

¹²⁵ See generally 17 C.F.R. § 240.19b-4(o).

¹²⁶ See generally Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249).

¹²⁷ See Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, 76 Fed. Reg. 36,287, 36,290 (June 22, 2011) (to be codified at 17 C.F.R. pt. 240).

requires the SEC, not market participants, to act.¹²⁸ Accordingly, the provision does not require compliance by relevant financial institutions “unless the relevant [SEC] action already has been undertaken.”¹²⁹ Until the SEC takes actions implementing this top-down review, regulated entities (like those listed in the CFTC Process Rule) will have no established role in providing data to inform clearing determinations, will receive no formal opportunity to comment on the decision-making process, and will have no guidance on if, or how, such determinations will be made in the future.

The SEC Process Rule does briefly mention commission-initiated review.¹³⁰ When discussing the background to Dodd-Frank and the regulatory approaches prescribed in Title VII, the SEC mentions in a footnote that “[t]he Dodd-Frank Act does not require rulemaking with respect to Commission-initiated Reviews.”¹³¹ In response to a comment requesting that the SEC follow the CFTC’s approach and promulgate rules on the subject, the SEC makes the same point; no further explanation is provided.¹³² The SEC merely adds that “staff are in the process of determining how these reviews will proceed . . . and whether any rulemaking related to these reviews is necessary, either now or in the future.”¹³³ Despite this claim, there has been no proposed or finalized rule in the time since the SEC Process Rule first referenced commission-initiated review of security-based swaps.¹³⁴ Additionally, the SEC’s online summary of Dodd-Frank implementation does

¹²⁸ *Id.* at 36,291 n.36.

¹²⁹ *Id.*

¹³⁰ *See generally* 17 C.F.R. § 240.19b-4(o) (2018).

¹³¹ *See* Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,604 n.16 (July 13, 2012) (to be codified at 12 C.F.R. pts. 240, 249).

¹³² *Id.* at 41,616 (“The [SEC] notes that the Dodd-Frank Act does not require rulemaking regarding Commission-initiated Reviews.”).

¹³³ *Id.*

¹³⁴ *See generally* 77–82 Fed. Reg. (2012–2017).

not indicate that any rule on commission-initiated review is proposed or expected.¹³⁵

Figure 2. CFTC and SEC Approaches to Mandatory Central Clearing¹³⁶

	CFTC	SEC
Jurisdiction	Swaps (~90% of the OTC derivatives market)	Security-Based Swaps (~10% of the OTC derivatives market)
Submissions of Voluntarily Cleared Swaps	Currently ongoing	Pending finalization of other rules
Submissions Made Publicly Available?	Yes	Unclear
Timeframe for Review of Submissions	Within 90 days	None
Commission-Initiated Review Procedures	Made on an ongoing basis after public comment process	Not addressed by rule or guidance
Products Currently Subject to Mandatory Clearing Requirement?	Yes	No

III. THE REGULATORY HOLE CREATED BY THE SEC'S APPROACH

The SEC's careful approach to initiating security-based swap submissions is understandable. Delaying implementation of the mandate until all relevant rules are finalized allows the SEC to avoid unnecessary market

¹³⁵ See *Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act*, U.S. SEC. & EXCHANGE COMMISSION, <https://www.sec.gov/spotlight/implementation-of-dodd-frank-act.shtml> [<https://perma.cc/MQ74-UMPK>] (last modified June 21, 2018).

¹³⁶ See *supra* Sections II.D.1–2.

disruptions and learn from the CFTC's missteps.¹³⁷ As discussed above, the SEC did not share the CFTC's political pressures to act quickly.¹³⁸ Although considerable time will have passed since Dodd-Frank's enactment once mandatory central clearing of security-based swaps begins, the statute itself grants the SEC the flexibility to sequence effective dates of rulemakings to minimize problems.¹³⁹

While the SEC's timing may not raise concerns, the substantive differences between the CFTC's and SEC's implementation of the central clearing mandate highlight serious issues. As discussed in Part II, Dodd-Frank provides two options for the Financial Regulators' use in making mandatory clearing determinations: the bottom-up submission process and the top-down commission-initiated review.¹⁴⁰ While the CFTC successfully began regulating OTC derivatives under its jurisdiction using the submission process, the agency's rulemakings specify that commission-initiated review will also be used when necessitated by changes in the market. Considering the nature of security-based swap products, the SEC's failure to provide similar guidance undermines the effective regulation envisioned by the statute.

A. Security-Based Swaps Are Not Suitable for a Submission-Only Process

By its nature, the SEC's submission process will only review those security-based swaps that are already voluntarily cleared or that central clearinghouses wish to clear in the future. The SEC has not explicitly argued that this

¹³⁷ Hammar et al., *supra* note 90, at 81 ("This [slower approach] allowed [the SEC] to take account of the CFTC experience[.]").

¹³⁸ See *supra* notes 96–98 and accompanying text; *supra* Section II.D.2.

¹³⁹ See Temporary Exemptions and Other Temporary Relief, Together with Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps, 76 Fed. Reg. 36,287, 36,289 (June 22, 2011) (to be codified at 17 C.F.R. pt. 240) ("Title VII provides the [SEC] with flexibility to establish effective dates beyond the minimum 60 days specified therein[.]").

¹⁴⁰ See *supra* notes 61–69 and accompanying text.

approach is preferable, and has given no explanation as to why it is taking this approach.¹⁴¹ However, there is no indication in any of the SEC's regulations or guidance that commission-initiated review will be added to the regulatory scheme later or that the submissions process is intended as a stopgap until commission-initiated review begins.¹⁴²

This submission-only method is poorly suited to security-based swaps, which include a substantial number of product types that are currently uncleared. The SEC is aware of this reality, noting in the SEC Process Rule that "many security-based swap transactions are still ineligible for central clearing."¹⁴³ At the time when the various OTC derivatives were defined as security-based swaps, only CDS products were voluntarily cleared by industry participants. Of those, ninety-one percent of index CDS products were accepted for clearing, but only thirty-three percent of single-name CDS were clearable at 2011 year-end.¹⁴⁴ An even smaller proportion of each product—fifty-seven percent of index CDS and twenty-five percent of single-name—were actually cleared.¹⁴⁵ According to this data, a significant percentage of the only clearable class of security-based swaps could not be cleared at finalization of the SEC Process Rule.

The proportion of security-based swaps voluntarily cleared has not increased meaningfully since. According to the Bank for International Settlements' most recent data, covering the first half of 2017, central counterparties account for slightly

¹⁴¹ See *supra* Section II.D.2.

¹⁴² See *supra* Section II.D.2. The SEC's choice to bury discussion of possible commission-initiated review in a footnote in the SEC Process Rule—and to relegate use of such review to agency discretion, abandoning public consideration of the possibility—strongly indicates that any hope the SEC will change course soon is misplaced.

¹⁴³ Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,636 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249).

¹⁴⁴ *Id.* at 41,638 tbl.1. Both percentages are measured by notional amount. *Id.*

¹⁴⁵ *Id.*

more than half of the gross outstanding notional amount of index CDSs, and around thirty percent of the gross outstanding notional amount in single-name CDSs.¹⁴⁶ The amount of equity OTC derivatives traded with central counterparties remains negligible.¹⁴⁷ Unsurprisingly, considering the SEC's regulatory stagnancy during the intervening time, it appears that the market's central clearing of security-based swaps remains unchanged.

As a result, a majority of security-based swaps currently traded in the market would not be subject to SEC review under the submission-only approach established by the SEC Process Rule. This would not change unless central clearinghouses decided to begin offering clearing services for previously uncleared security-based swaps, triggering submissions on those products. Similarly, new security-based swap products emerging in the market would not be subject to SEC review unless a central clearing party wished to offer clearing services for it. In both cases, though, industry participants—and not the Financial Regulators—would control which products could potentially be included in the central clearing mandate.

B. One Size Does Not Fit All: The CFTC's Approach

¹⁴⁶ *Semiannual OTC Derivatives Statistics, Global OTC Derivatives Market: Commodity Contracts, Credit Default Swaps*, BANK OF INT'L SETTLEMENTS, http://stats.bis.org/statx/srs/tseries/OTC_DERIV/H:N:A:Y:R:A:A:5A:5J?t=D5.2&p=20171&i=28.4&x=OD_CPARTY.5.CL_OD_CPARTY&o=s:line,z:3 [perma.cc/S2JW-3JNS] (showing number of Index CDS trades with central clearing parties); *Semiannual OTC Derivatives Statistics, Global OTC Derivatives Market: Commodity Contracts, Credit Default Swaps*, BANK OF INT'L SETTLEMENTS, http://stats.bis.org/statx/srs/tseries/OTC_DERIV/H:N:D:Y:N:A:A:5A:5J?t=D5.2&p=20171&i=26.8&x=OD_CPARTY.5.CL_OD_CPARTY&o=s:line,z:3 [perma.cc/X8VS-QBSK] (showing number of single-name CDS trades with central clearing parties).

¹⁴⁷ *Semiannual OTC Derivatives Statistics, Global OTC Derivatives Market: Commodity Contracts, Foreign Exchange, Interest Rate, Equity Linked Contracts*, BANK OF INT'L SETTLEMENTS, <http://stats.bis.org/statx/srs/table/d5.1> [perma.cc/UZ3K-J7SW] (showing equity trades with central counterparties).

Does Not Work for the SEC

Although the SEC has not attempted to justify its planned treatment of commission-initiated review, it may argue that the CFTC's success in implementing the central clearing mandate illustrates that the commission-initiated review option is unnecessary. Both CFTC rules implementing the central clearing requirement were promulgated on the basis of swap submissions rather than through top-down agency review.¹⁴⁸ Some observers note that the SEC's slower regulatory approach allows it to learn from the CFTC's choices, and tailor its rules accordingly.¹⁴⁹ As part of this deliberate strategy, the SEC could claim it consciously decided to forego commission-initiated review because the CFTC has not yet found use for it.

This decision would be a critical regulatory misstep for three important reasons. First, security-based swaps are currently less likely to be voluntarily cleared or even clearable with central clearing parties. Second, industry participants generally consider security-based swaps less appropriate for clearing and are therefore less likely to pursue voluntary clearing of security-based swaps without regulatory encouragement. And third, the CFTC's approach took advantage of existing regulatory incentives to push the market towards voluntary clearing; without commission-initiated review, the SEC will struggle to benefit from similar forces.

1. Current Clearing of Security-Based Swaps Limit Submissions' Effectiveness

The CFTC's use of submissions was particularly effective because most of the swaps market was already clearable at the time of the clearing requirement determinations. The

¹⁴⁸ See Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,287 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39, 50); Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps, 81 Fed. Reg. 71,202, 71,205–06 (Oct. 14, 2016) (to be codified at 17 C.F.R. pt. 50).

¹⁴⁹ See Hammar et al., *supra* note 90, at 81.

Initial CFTC Clearing Mandate estimated that the interest rate swaps covered therein made up about three quarters of the swaps market's outstanding notional exposure.¹⁵⁰ That rule covered other types of swaps as well, and the 2016 regulation added further product classes.¹⁵¹ Since all of these types of swaps were reviewed pursuant to central clearing parties' submissions, it is reasonable to conclude that a majority of the swap market was voluntarily cleared (or central clearing parties sought to offer voluntary clearing) at the time of the determinations.

By contrast, security-based swaps are not voluntarily cleared in any significant volume. In 2012, when the SEC promulgated the SEC Process Rule, security-based swaps were not only largely uncleared, they were generally *unclearable* through central clearing parties—no such party accepted them for voluntary clearing.¹⁵² As discussed above in Part II.A, these numbers have not considerably changed, and so a major portion of the current security-based swaps market remains unreviewable through a submission-only process.

2. Market Purposes for Security-Based Swaps Encourage Inertia

More crucially, the current, limited state of security-based swaps clearing is likely to continue absent external forces on the market. According to the International Swaps and Derivatives Association (“ISDA”) and a variety of other industry associations and regulators, a “substantial portion” of the OTC derivatives market is likely to remain uncleared

¹⁵⁰ Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. at 74,287.

¹⁵¹ See *id.* at 74,284; Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps, 81 Fed. Reg. 71,202, 71,202 (Oct. 14, 2016) (to be codified at 17 C.F.R. pt. 50).

¹⁵² See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,638 tbl.1 (July 13, 2012); see also *supra* Section III.A.

moving forward.¹⁵³ This segment is primarily composed of security-based swaps, including the majority of single-name credit default swaps and many equity swaps.¹⁵⁴

ISDA's explanations for why security-based swaps are often uncleared illustrate why the market is unlikely to unilaterally adopt voluntary clearing. These products are less amenable to central clearing for several reasons, including end-users' needs for tailored, bespoke products, particularly for hedging or risk management purposes; lack of product standardization; lack of clearinghouse capability;¹⁵⁵ and lack of liquidity.¹⁵⁶ While industry focus and investment could solve some of these issues, security-based swaps' popularity as bespoke hedging products makes it unlikely that market participants will devote resources to solving the problem on their own. According to ISDA, requiring hedging parties to use standardized products would force them to "employ imperfect or unsuitable hedges . . . [with] unwanted basis risk."¹⁵⁷ Further, standardization would potentially restrict

¹⁵³ See generally INT'L SWAPS & DERIVATIVES ASS'N, NON-CLEARED OTC DERIVATIVES: THEIR IMPORTANCE TO THE GLOBAL ECONOMY 4 (Mar. 2013) [hereinafter ISDA REPORT] (discussing similar observations made by the Financial Security Board, Basel Committee on Banking Supervision, the Board of Governors of the International Organizations of Securities Commissions, and the International Monetary Fund).

¹⁵⁴ *Id.* ("ISDA estimates the non-cleared OTC derivatives market will consist of the following: [s]everal large, relatively broad market segments, including the majority of . . . single-name credit default swaps and various types of equity . . . swaps[.]").

¹⁵⁵ Clearinghouse capability could likely be voluntarily developed. However, without a market for voluntary clearing, it is unlikely clearinghouses will develop this capability; at the same time, the lack of ready-and-waiting clearinghouse ability will limit market interest in taking the needed steps to render products clearable. This feedback loop—along with the other factors listed—leaves it unlikely the private market will move towards voluntary clearing without an external stimulus.

¹⁵⁶ *Id.* at 10–12. As explained in Section II.A, *supra*, establishing a perfect hedge requires tailoring the derivative transaction to the underlying security. Even where not attempting to use swaps for hedging purposes, the bespoke nature of many OTC derivatives is useful to market participants who wish to create a specific, niche risk profile. See *supra* notes 33–35 and accompanying text.

¹⁵⁷ ISDA REPORT, *supra* note 153, at 5.

transactions from qualifying for hedge accounting treatment, “introduc[ing] significant volatility to [hedging parties]’ income statements.”¹⁵⁸ If the popular industry belief is that voluntarily cleared security-based swaps will not fulfill parties’ purposes, it is doubtful that market participants will spend time and money pursuing voluntary clearing of any security-based swaps unless forced to do so.

3. Lack of Regulatory Incentives Will Promote Continuation of the Status Quo

Finally, without a commission-initiated review option, it is unclear how the SEC plans to incentivize voluntary clearing—the first step in the mandatory central clearing process under a submission-only scheme. In a fully operative Title VII regulatory regime, the SEC would review security-based swap products and potentially subject them to the central clearing requirement regardless of whether market participants voluntarily clear such products. In such circumstances, industry members would have the opportunity to avoid unnecessary costs and disruptions to their trading by making products more suitable for clearing in advance of an SEC determination.

The CFTC’s submission-focused approach benefitted from a general market understanding that mandatory central clearing would soon be implemented for swaps.¹⁵⁹ The CFTC Process Rule’s inclusion of specific commission-initiated review methods bolstered this expectation, even though they have not been used. While ISDA noted that increased central clearing began before the financial crisis,¹⁶⁰ this shift accelerated following the industry commitment to “broaden the range of cleared swaps and market participants.”¹⁶¹

¹⁵⁸ *Id.*

¹⁵⁹ *See supra* notes 96–98 and accompanying text.

¹⁶⁰ *Id.* at 7 (“To summarize, the trend toward central clearing predates the financial crisis and has accelerated since the crisis.”).

¹⁶¹ Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74,284, 74,296 (Dec. 13, 2012) (to be codified at 17 C.F.R. pts. 39, 50).

Industry members began to change their approach in direct response to “key concerns raised by supervisors and legislators globally.”¹⁶² The CFTC could rely on the submission process in the Initial CFTC Clearing Mandate specifically because widespread, voluntary swap clearing had already taken hold in the market as a response to the threat of regulation.¹⁶³ Similarly, regulators made the Additional CFTC Clearing Mandate determination based on submissions of types of swaps then uncleared by the submitting organizations, but which the organizations wished to voluntarily clear moving forward.¹⁶⁴ Without any risk of top-down CFTC review of these products (i.e., without a potential clearing obligation), it is unclear whether industry participants would have unilaterally standardized and cleared them.

As security-based swaps are less likely than swaps to be voluntarily cleared or clearable, incentivizing voluntary clearing is essential to the SEC’s mandatory clearing process. Exemplifying the impact such incentives could have, major buy-side firms have already committed to voluntarily clear the one security-based swap product that the eventual central clearing requirement will certainly cover—liquid single-name CDS.¹⁶⁵ Such a voluntary move is unlikely to occur in the

¹⁶² Letter from Senior Mgmts. of Dealers & Buy-Side Insts. to William C. Dudley, President, Fed. Reserve Bank of N.Y. (June 2, 2009), https://www.newyorkfed.org/medialibrary/media/newsevents/news/market_s/2009/060209letter.pdf [perma.cc/DK7K-EBJV].

¹⁶³ See Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44,464, 44,469 (July 26, 2011) (to be codified at 17 C.F.R. pts. 39, 140) (“The [CFTC] anticipates that the initial mandatory clearing determinations would only involve swaps that are either already being cleared or that a [derivatives clearing organization] wants to clear.”); see also Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. at 74,287 (noting the swaps covered under the Initial CFTC Clearing Mandate were “currently being cleared”).

¹⁶⁴ See Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps, 81 Fed. Reg. 71,202, 71,206 (Oct. 14, 2016) (to be codified at 17 C.F.R. pt. 50).

¹⁶⁵ See Press Release, Int’l Swaps & Derivatives Ass’n, 25 Investment Management Firms Commit to Single-Name CDS Clearing (Dec. 16, 2015),

market for other products, though; as discussed above, bespoke security-based swaps' usefulness for hedging purposes—and the broader popularity of their bilaterally negotiated nature—makes it unlikely parties will abandon these products.¹⁶⁶ Considering that standardization would sacrifice this utility, it would be a poor plan to rely on industry members expending their own resources to find ways to standardize these products.¹⁶⁷ Making it inevitable that the central clearing mandate will reach currently unclearable products is the most effective way to push the market toward voluntary clearing. But under the submission-only processes in the SEC Process Rule, this regulatory incentive is conspicuously absent.

While the margin requirements for uncleared security-based swaps may help fill this void, ISDA finds this unlikely.¹⁶⁸ The report notes that margin requirements “which are intended to incentivize central clearing will not achieve the objective . . . but will simply dissuade derivatives users from engaging in otherwise economically useful investment or risk-hedging activity.”¹⁶⁹ Without additional incentives, the increased cost of trading uncleared products alone is not enough to counteract the significant market tendency against central clearing of security-based swaps.

Between the current uncleared nature of many security-based swaps, the lack of market interest in voluntary clearing, and the absence of regulatory incentives pushing industry members to pursue voluntary clearing moving forward, it is difficult to see how the SEC's submission-only process will succeed. Unless the SEC adjusts its approach, many of the products under its jurisdiction will escape review and

<https://www.isda.org/2015/12/16/25-investment-management-firms-commit-to-single-name-cds-clearing> [perma.cc/DU9W-VCU9].

¹⁶⁶ See *supra* Section III.B.3.

¹⁶⁷ As private firms would need to expend their own resources developing a fix that would then be used by (and, through regulation, required of) the rest of the industry, it would be a poor business decision to voluntarily pursue standardization without any cost-sharing mechanism.

¹⁶⁸ See ISDA REPORT, *supra* note 153, at 16.

¹⁶⁹ *Id.*

mandatory central clearing. Although the CFTC's submissions-only approach has been successful in the swaps market, the SEC must take a unique approach to cover the specific market under its control.

C. Mandatory Central Clearing: The SEC's Obligation to Implement Congress' Intent

Considering the legislative intent discussed in Subsection II.B.1, the SEC's approach clearly undermines Title VII's purposes.¹⁷⁰ Congress intended Dodd-Frank to mitigate the systemic risk of the OTC derivatives market with close, ongoing review of the market and widespread central clearing implemented pursuant to such review.¹⁷¹ By excluding active top-down review, the SEC impeded its own ability to review a significant portion of the market it was meant to regulate. More dangerously, the SEC has abdicated its responsibility to make central clearing determinations, only becoming involved when market participants initiate the process with voluntary clearing. By allowing financial institutions to determine whether mandatory central clearing of security-based swaps occurs, the SEC has undermined a core provision of Dodd-Frank's regulatory scheme.

Some Dodd-Frank critics may see the SEC's lack of effective central clearing as a positive development. Once global regulatory discussions began focusing on mandatory central clearing as a potential response to the financial crisis, many academics took aim at the concept's effectiveness as a risk-mitigation device.¹⁷² Such concerns were significant

¹⁷⁰ See *infra* notes 57–60 and accompanying text.

¹⁷¹ See *supra* Section II.C.1.

¹⁷² See, e.g., Sean J. Griffith, *Substituted Compliance and Systemic Risk: How to Make a Global Market in Derivatives Regulation*, 98 MINN. L. REV. 1291, 1294 (2014) (“[R]ecent scholarship shows that mandatory clearing is no panacea for systemic risk, and once it is imposed on a globally uniform basis, its flaws will be unchecked, rendering the global financial system uniformly vulnerable.”); Yuliya Guseva, *Destructive Collectivism: Dodd-Frank Coordination and Clearinghouses*, 37 CARDOZO L. REV. 1693, 1715 (2016) (“[T]he centralized clearing of OTC derivatives . . . may be unduly overrated.”); Hester Peirce, *Derivatives Clearinghouses: Clearing the*

enough for the SEC to note them in the SEC Process Rule.¹⁷³ Scholar and now-SEC Commissioner Hester Peirce effectively summarized critics' most prominent concern, that central clearing parties have become "Dodd-Frank's addition to the too-big-to-fail ranks[.]"¹⁷⁴ with the risk that "a shuttered [central clearing party] could devastate markets[.]"¹⁷⁵ With such catastrophic potential effects, these critics surely find the SEC's approach—which limits both the coverage of the central clearing mandate and the regulatory incentives for private parties to pursue voluntary clearing—a welcome respite from regulation.

Unfortunately for these critics, the policy debate ended in Congress. Dodd-Frank did not ask the SEC to examine the

Way to Failure, 64 CLEV. ST. L. REV. 589, 589 (2016) ("Risk management by clearinghouses and market participants could suffer, and improper risks could find their way into clearinghouses. . . . Dodd-Frank's derivatives framework should be reconsidered before it destabilizes the financial system."); Mark J. Roe, *Clearinghouse Overconfidence*, 101 CALIF. L. REV. 1641, 1641 ("[C]learinghouses are weaker bulwarks against financial contagion, financial panic, and systemic risk than is commonly thought. . . . [T]hey do little to reduce systemic risk in crisis times."); Yesha Yadav, *The Problematic Case of Clearinghouses in Complex Markets*, 101 GEO. L.J. 387, 387 (2013) ("If a clearinghouse cannot manage its risks, the consequences are invariably systemic and enormously costly to the taxpayer.").

¹⁷³ See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,639 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249) ("Others contend that concentrating the risk of numerous bilateral counterparties in a single [central clearing party] (or a small number of [central clearing parties]) could introduce risks and incentives that may not otherwise exist. For example, they believe that risk sharing through a central counterparty may encourage excessive risk taking if the costs of imprudent decisions by one clearing member are borne by other clearing members, and generally would not be more effective in mitigating systemic risk than bilateral clearing arrangements between individual firms. Moreover, at least one party believes this moral hazard problem could be exacerbated to the extent that [central clearing parties] are viewed as too important to fail and subject to bailout remedies that benefit all [central clearing party] members.") (internal citations omitted).

¹⁷⁴ Peirce, *supra* note 172, at 621.

¹⁷⁵ *Id.* at 647.

efficacy of mandatory central clearing and establish its processes accordingly. Title VII instead obligates the SEC to carry out the goal of mandatory central clearing for OTC derivatives.¹⁷⁶ While the SEC retains the power to decide that some specific products are not suitable for central clearing, it cannot wield this authority to undermine Title VII's overall purpose. Once Congress expressed its intent, any internal SEC argument over central clearing as a regulatory tool should have ended. It is worth noting the SEC appears to share this view, as it declined to respond to these concerns beyond noting them in the SEC Process Rule.¹⁷⁷

Other clearing skeptics may claim that while the central clearing mandate is warranted, the specific characteristics that make security-based swaps less likely to be voluntarily cleared also make SEC review unnecessary. These critics would claim that, even after SEC review, such products would not be subject to the central clearing requirement. Several of the ISDA report's reasons why security-based swaps will remain uncleared, including insufficient liquidity and lack of operational capability,¹⁷⁸ are included in the factors Dodd-Frank requires the SEC to consider when making mandatory central clearing determinations.¹⁷⁹ Dodd-Frank also addresses the serious concern regarding hedging products directly through the end-user exception, which exempts non-financial entities using security-based swaps to mitigate commercial risk from the central clearing requirement.¹⁸⁰

¹⁷⁶ See 15 U.S.C. §§ 78c-3(a)–(b) (2012).

¹⁷⁷ See Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,639 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249).

¹⁷⁸ See *supra* notes 154–58 and accompanying text.

¹⁷⁹ See 15 U.S.C. § 78c-3(b)(4)(B)(i)–(ii) (2012) (“[T]he [SEC] shall take into account[:] (i) The existence of significant outstanding notional exposures, trading liquidity and adequate pricing data. (ii) The availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure[.]”).

¹⁸⁰ See 15 U.S.C. § 78c-3(g)(1) (2012). As discussed in Section II.D.2., *supra*, the end-user exception will go into effect via an SEC rule which will

Although these provisions show Congress' understanding that the OTC derivatives market cannot be regulated with a one-size-fits-all approach, they do not allow the SEC to ignore sections of the security-based swap market. The SEC may eventually determine a specific product type should not be subject to the central clearing mandate, but it remains imperative that the SEC *actually conducts* the review leading to that determination. As ISDA notes, "contrary to popular belief, OTC derivatives with bespoke economic terms can be and are cleared."¹⁸¹ To assume—without investigating—that certain products cannot be centrally cleared would preempt the precise type of creative solutions for which Congress enlisted the SEC's expertise. And even if the SEC made such an assumption regarding *currently* unclearable security-based swaps, this approach abandons responsibility for any new security-based swap products market participants may later create.

Finally, any argument in favor of the current approach underestimates the positive impact of regulatory certainty. The market's awareness of when and how the SEC reviews a product—and of when that review will result in obligations for private actors—allows the market to function efficiently. Citadel LLC, a global investment firm, recently implored the SEC to finalize security-based swap rules and implement mandatory clearing for commonly traded CDSs in order to "provide the market with . . . regulatory certainty."¹⁸² According to Citadel, the lack of clear guidance and predictability has impaired liquidity and participation in the market.¹⁸³ Notably, the SEC's only discussion of commission-

establish a notification procedure for parties who wish to take advantage of it. This rule was proposed in 2010 but has not yet been finalized. *See* SEC End-User Exception to Mandatory Clearing of Security-Based Swaps (Proposed Rule), 75 Fed. Reg. 79,992 (Dec. 21, 2010). The CFTC equivalent rule was finalized in 2012. *See* 17 C.F.R. § 50.50 (2018).

¹⁸¹ ISDA REPORT, *supra* note 153, at 5.

¹⁸² Letter from Adam C. Cooper, Senior Managing Dir. & Chief Legal Officer, Citadel, to Brent J. Fields, Sec'y, Sec. & Exch. Comm'n 2 (Feb. 2, 2016), <https://www.sec.gov/comments/s7-05-12/s70512-24.pdf> [perma.cc/4DU3-VT34].

¹⁸³ *Id.* at 1.

initiated review in the SEC Process Rule was in response to a commenter's similar request for clarity.¹⁸⁴ A scheme in which the SEC intentionally avoids top-down review of products, regardless of the reason, would strip the market of needed guidance and certainty.

IV. JUDICIAL AND POLITICAL OVERSIGHT: FORCING THE REGULATOR TO REGULATE

Unfortunately, convincing the SEC to voluntarily adopt Commission-initiated review may prove difficult in the current political climate. President Donald Trump has expressed disdain for Dodd-Frank generally.¹⁸⁵ Republican members of the House of Representatives led the passage of a 2017 bill which would roll back many of Dodd-Frank's financial protections; a more limited version, which does not reach the central clearing mandate, was eventually passed and signed into law.¹⁸⁶ The Treasury Department similarly took aim at the statute, citing an extended period of slow economic growth,¹⁸⁷ and identified mandated clearing of derivatives for reexamination "with an eye toward

¹⁸⁴ See SEC Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,616 (July 13, 2012) (to be codified at 17 C.F.R. pts. 240, 249).

¹⁸⁵ See, e.g., Donald J. Trump (@realDonaldTrump), TWITTER (June 9, 2017, 7:22 AM), <https://twitter.com/realDonaldTrump/status/873183401620230144> [perma.cc/N94Z-QK9Z] ("Congratulations to Jeb Hensarling & Republicans on successful House vote to repeal major parts of the 2010 Dodd-Frank financial law. GROWTH!").

¹⁸⁶ For the House bill, see Financial CHOICE Act of 2017, H.R. 10, 115th Cong. (2017). For a discussion of the law eventually passed by both houses, see Alan Rappeport & Emily Flitter, *Congress Approves First Big Dodd-Frank Rollback*, N.Y. TIMES (May 22, 2018), <https://www.nytimes.com/2018/05/22/business/congress-passes-dodd-frank-rollback-for-smaller-banks.html> (on file with the *Columbia Business Law Review*).

¹⁸⁷ Press Release, U.S. Dep't of the Treasury, Treasury Releases Second Report on the Administration's Core Principles of Financial Regulation (Oct. 6, 2017), <https://www.treasury.gov/press-center/press-releases/Pages/sm0173.aspx> [perma.cc/QTZ7-RPAA].

maximizing economic growth consistent with taxpayer protection.”¹⁸⁸ While Democrats now control the House of Representatives,¹⁸⁹ the significant uncertainty surrounding Dodd-Frank’s status in the current administration makes it doubtful the SEC will rewrite its approach of its own volition, regardless of how crucial such changes are to the statute’s efficacy.

Despite this possible resistance, private actors may be able to compel SEC action through other routes. The standard approach to raising objections to agency action (or, in this case, lack of action) is via suit under the Administrative Procedure Act.¹⁹⁰ While limited precedent may provide a strategic blueprint for a successful case in this situation, potential litigants would face significant hurdles both on the merits of the argument and questions of standing, so litigation may prove difficult. Sympathetic lawmakers, who could assert closer oversight from their roles on congressional committees and relationships with SEC commissioners, could potentially pursue a more productive route. Both avenues may prove necessary to draw attention to and fix the SEC’s ineffective regulatory structure.

A. *Massachusetts v. EPA*: A Framework for Compelling Agency Action

Forcing federal agencies to act when they do not wish to is a particularly difficult task under the Administrative Procedure Act. As the Supreme Court has acknowledged, “an

¹⁸⁸ U.S. DEPT OF THE TREASURY, A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES 5 (Oct. 2017), <https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf> [perma.cc/V2V8-JYHB].

¹⁸⁹ See Phillip Rucker, Matt Viser, Elise Viebeck & Issac Stanley-Becker, *Midterm Elections: Democrats Capture House as GOP Holds Senate*, WASH. POST (Nov. 7, 2018), https://www.washingtonpost.com/politics/midterm-elections-democrats-flip-house-as-gop-expands-senate-majority/2018/11/07/94d62430-e27d-11e8-8f5f-a55347f48762_story.html?utm_term=.82b34fb0518f [perma.cc/E6BL-EH2K].

¹⁹⁰ See 5 U.S.C. § 706 (2012) (defining the scope of judicial review under the Administrative Procedure Act).

agency has broad discretion to choose how best to marshal its limited resources and personnel to carry out its delegated responsibilities.”¹⁹¹ However, agency refusals to initiate rulemaking remain subject to judicial review so as to vindicate the public’s rights to file petitions for rulemaking and receive a public explanation of denials.¹⁹²

This judicial review is “‘extremely limited’ and ‘highly deferential,’”¹⁹³ making it unlikely litigation will succeed, but courts have granted relief where the failure to engage in rulemaking is clearly in violation of congressional instructions. The paradigm case for such relief arose in *Massachusetts v. Environmental Protection Agency*, where the Supreme Court required the Environmental Protection Agency (the “EPA”) to take regulatory action because the Clean Air Act “provides that EPA shall by regulation prescribe . . . standards.”¹⁹⁴ This language obliged the EPA to release standards for air pollutants that may negatively impact public health.¹⁹⁵ Once such a negative impact was determined, failing to regulate was a violation of the statutory mandate, unless the EPA was able to provide a reason (in light of the statute’s text and purposes) that such inaction was preferable.¹⁹⁶ Although the EPA “offered a laundry list of reasons not to regulate,” none related to the actual text of the statute.¹⁹⁷ This failure to act in light of Congress’ instructions

¹⁹¹ See *Massachusetts v. Env’tl. Prot. Agency*, 549 U.S. 497, 527 (2007).

¹⁹² *Id.* (“Refusals to promulgate rules are thus susceptible to judicial review[.]”).

¹⁹³ *Id.* at 527–28 (citing *Nat’l Customs Brokers & Forwarders Ass’n. of Am., Inc. v. United States*, 883 F.2d 93, 96 (D.C. Cir. 1989)).

¹⁹⁴ *Id.* at 528 (internal quotation marks omitted).

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* at 532–33 (“While the statute does condition the exercise of EPA’s authority on its formation of a ‘judgment,’ . . . that judgment must relate to whether an air pollutant ‘cause[s], or contribute[s] to, air pollution which may reasonably be anticipated to endanger public health or welfare,’ Put another way, the use of the word ‘judgment’ is not a roving license to ignore the statutory text. It is but a direction to exercise discretion within defined statutory limits.”).

¹⁹⁷ *Id.* at 533–34 (“Although we have neither the expertise nor the authority to evaluate these policy judgments, it is evident they have nothing

amounted to an executive “refusal to execute domestic laws.”¹⁹⁸

Despite the permissive standard of review applied to agency inaction, courts may come to a similar conclusion regarding the SEC’s refusal to conduct commission-initiated review. Dodd-Frank states that the SEC “on an ongoing basis *shall* review each security-based swap . . . to make a determination that such security-based swap . . . should be required to be cleared.”¹⁹⁹ Congress’ intent is clear—the SEC must review every product type within its jurisdiction and make a clearing mandate determination for each. Since the regulatory strategy established in the SEC Process Rule will fail to do so the agency is in violation of the statutory mandate.²⁰⁰

The SEC may argue that Dodd-Frank, unlike the Clean Air Act, does not require it act “by regulation,”²⁰¹ and therefore its note in the SEC Process Rule that it would not initiate rulemaking is not a violation of the statute.²⁰² However, as the Supreme Court noted, “agency refusals to initiate rulemaking are . . . subject to special formalities, including a public explanation.”²⁰³ The EPA failed to justify how its failure to act, despite clear instruction from Congress, would promote the purposes Congress provided. The SEC’s approach is even more egregious: it has failed to provide *any* explanation of its approach to commission-initiated review, whether in light of Dodd-Frank’s goals and instructions or

to do with whether greenhouse gas emissions contribute to climate change. Still less do they amount to a reasoned justification for declining to form a scientific judgment.”).

¹⁹⁸ *Id.* at 534.

¹⁹⁹ 15 U.S.C. § 78c-3(b)(1)(A) (2012) (emphasis added).

²⁰⁰ *See supra* Part III.

²⁰¹ *See* Clean Air Act, 42 U.S.C. § 7521 (2012).

²⁰² *See* Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations, 77 Fed. Reg. 41,602, 41,604 n.16 (July 13, 2012) (to be codified at 12 C.F.R. pts. 240, 249).

²⁰³ *Massachusetts v. EPA*, 549 U.S. at 527 (internal quotation marks omitted).

otherwise. The SEC Process Rule provided no response to the discussions in Part III of this Note regarding the nature of security-based swaps products or industry concerns regarding uncertainty in the market. On its own, the agency's failure to justify the submission-only approach should be considered a violation of the statute akin to the one found in *Massachusetts v. EPA*.

B. The Pitfalls: The Constitutional Standing Requirement of Injury-in-Fact

While a suit brought against the SEC for failure to regulate may be successful, it could be difficult to find a party who is both willing and able to sue. The constitutional minimum of standing, as established by the Supreme Court, requires (1) an injury-in-fact, (2) causation, and (3) redressability.²⁰⁴ As the injury must be concrete and particularized, and actual or imminent,²⁰⁵ this element will be particularly difficult for most parties to establish.

The potentially regulated parties—the financial institutions trading security-based swaps which would be subject to the central clearing mandate—should be able to establish injury-in-fact if they choose to bring suit. The uncertainty resulting from the SEC's approach and the related disruption to security-based swaps markets should be enough to show injury and allow the suit to proceed. However, though regulated parties have already expressed concerns,²⁰⁶ security-based swap traders may not wish to take on the cost of a lawsuit. The “Pandora's box” uncertainty of the regulatory action they could prompt will also likely further deter such litigation. Because the SEC's commission-initiated review could lead to unexpected results, the eventual regulation may be costly to the individual entity bringing the suit or benefit its competitors. For these reasons, it would be unavailing to look to financial entities to serve as plaintiffs, even though they have the clearest access to judicial review.

²⁰⁴ *Lujan v. Defs. of Wildlife*, 504 U.S. 555, 560–61 (1992).

²⁰⁵ *Id.* at 560.

²⁰⁶ *See Cooper*, *supra* note 182, at 2.

Unfortunately, although members of the public may be able to petition the SEC to engage in rulemaking, it is doubtful they could establish the injury element for standing to sue if the SEC refuses to comply. In *Lujan v. Defenders of Wildlife*, environmental groups—the ostensible regulatory beneficiaries of the Endangered Species Act—did not have standing to sue over agencies’ alleged procedural violations.²⁰⁷ The Court held that “a plaintiff raising only a generally available grievance about government—claiming only harm to his and every citizen’s interest in proper application of the Constitution and laws . . . does not state an Article III case or controversy.”²⁰⁸ The SEC’s rejection of future petitions to regulate is a similar procedural harm, and accordingly would not be enough to show injury.

Instead, creative plaintiffs may claim that the SEC’s failure to act heightens the systemic risk Dodd-Frank meant to combat, and therefore all participants in the national economy should have standing to sue. This contention is also likely to fail, though, as it is doubtful this injury is sufficiently particularized, concrete, and imminent enough to satisfy courts. Therefore, it will be difficult for the average citizen to establish standing and pursue a case against the SEC on its merits.

C. Political Accountability: Using Elected Officials to Pressure the SEC into Action

As a private suit may not be a productive solution to the issue, it may be worthwhile to look to the source of the mandate: Congress itself. Although Dodd-Frank was passed by a prior Congress, current members of the House and Senate should act to ensure the legislation accomplishes its intended effect. Even with Democrats in control of the House, uncertainty remains about the potential of amendment of Dodd-Frank, but minority senators or house Democrats could use oversight powers to conduct hearings and push the SEC toward more effective regulatory solutions. Indeed, members

²⁰⁷ See *Lujan*, 504 U.S. at 555.

²⁰⁸ *Id.* at 573–74.

of the Senate Committee on Banking, Housing, and Urban Affairs have previously pressured the SEC on implementation of other provisions of Dodd-Frank.²⁰⁹ It is possible that these senators have not taken similar action on the central clearing mandate because of the focus on the CFTC's activity and the SEC's opacity in establishing its eventual process. But if the central clearing requirement and its risk-prevention and transparency benefits are to be realized in the security-based swaps market, such involvement may be necessary here as well.

To assist this effort, further study would prove particularly useful. While political actors will be less inclined to slow economic growth with regulatory approaches targeting potential systemic risk, evidence that implementation of the central clearing mandate benefits markets may have more of an impact. Bank of England researchers have engaged in some of this analysis—but looked only to the performance of a single product type (vanilla interest rate swaps) under the CFTC's jurisdiction—since use of swap execution facilities and the central clearing mandate began.²¹⁰ The differences between the CFTC's and the SEC's Dodd-Frank implementations provide a distinct opportunity to expand this analysis and examine the statistical impact of the SEC's lack of action in particular.

An empirical analysis could compare, for example, the broad-based CDS index market (currently subject to the CFTC's central clearing requirement) and the single-name CDS market (part of the SEC's uncovered Title VII jurisdiction) at points both prior to and after the implementation of the Initial CFTC Clearing Mandate.

²⁰⁹ See, e.g., Sarah N. Lynch, *Four Democrats Seek Probe into Reviews Ordered by Acting SEC Chair*, REUTERS (Mar. 29, 2017), <https://www.reuters.com/article/us-usa-sec-senate/four-democrats-seek-probe-into-reviews-ordered-by-acting-sec-chair-idUSKBN1702XN> [perma.cc/8B3N-V8UR].

²¹⁰ See Evangelos Benos, Richard Payne & Michalis Vasios, *Centralized Trading, Transparency and Interest Rate Swap Market Liquidity: Evidence from the Implementation of the Dodd-Frank Act* (Bank of Eng., Working Paper No. 580, 2018).

Review of these products' volume, bid-ask spread, execution costs, and other statistical indicators of market depth and liquidity could shed some light on the regulations' impacts on market efficiency and systemic risk. Such a study could additionally illustrate the specific impacts of the uncertainty (as discussed in the Citadel letter²¹¹) the SEC's approach causes. If this analysis enhances the Bank of England's findings that "centralized trading, as mandated by Dodd-Frank" increased activity and improved liquidity,²¹² it may prompt or assist the political pressure advocated for herein. Regardless of the results, such a study would also provide some much-needed clarity in the ongoing debate surrounding the efficacy of central clearing as a regulatory approach to risk and market efficiency.²¹³

V. CONCLUSION

Ten years on, some of the worst impacts of the financial crisis have faded from public view. While regulatory and market forces have changed the shape of the economy, the political imperatives created by the crisis's turbulence have ebbed and many no longer treat the need for solutions as urgent. Despite these receding political incentives, though, it is critical that the Financial Regulators continue to fulfill their mandates and prevent another catastrophe.

The central clearing mandate initially emerged as a crucial regulatory reform on a global scale. For its proponents, including those responsible for determining the scope of regulatory reforms, central clearing would help fix the instability and opacity of the OTC derivatives market. Widespread central clearing could prevent the domino-effect collapses and conflagration of fear that catalyzed the market crashes of 2008. For these goals to come to fruition, Dodd-Frank's original intent must be upheld. Although the CFTC's implementation has been successful in a portion of the market, the SEC must change its current approach and fulfill

²¹¹ See Cooper, *supra* note 182, at 2.

²¹² See Benos et al., *supra* note 210, at 1.

²¹³ See *supra* Section III.C.

its side of the bargain. Hopefully, with changes to the SEC approach as outlined herein, the Financial Regulators will plan the necessary roles to prevent such problems from arising anew.