HARVARD BUSINESS LAW REVIEW Online

STRAIGHT TALK FROM A PRACTITIONER: NOTES FROM UNDER THE WALL

Steven Lofchie with assistance from Theresa Perkins***

As a financial regulatory lawyer, I am accustomed to being cautious in my pronouncements. Equivocal and timid. When clients ask me for hard advice, rather than answer them, I often just rub my hands together like Uriah Heep and mumble, "that is a very good question." If you search me on the Internet, you will see that my writing resulted in one commenter describing me as "the world's most boring man."[1]

Nonetheless, I can tell you with absolute certainty, flat opinion—none of those scrivener "it's the better view" qualifications—that Dodd-Frank just does not work. It's a horrorshow. In fact, sometimes I get so agitated in my opposition to the statute that, when I speak, my hands tremble as with palsy, my eyes redden with little flecks, and I let fly bits of spittle.[2]

So it surprises me, frustrates me, infuriates me, that the statute has its many and public defenders. The newspapers still love it.[3] So I bemoan and let fly.

Two Debates?

There are, in fact, two debates going on about Dodd-Frank. Actually, "debates" is the wrong word. Dodd-Frank proponents (the newspapers, the general public, even my

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[1] Steven Lofchie, *We Salute You!*, SMALL THOUGHTS, Mar. 26, 2009, http://xerpentine.blogspot.com/2009/03/steven-lofchie-we-salute-you.html.

[2] *See also* FEODOR DOSTOEVSKY, NOTES FROM THE UNDERGROUND 1 ("I am a sick man.... I am a spiteful man. I am an unattractive man. I believe my liver is diseased.").

[3] *See, e.g.*, Edward Wyatt, *Financial Reforms of Dodd-Frank Act Still Under Fire a Year Later*, N.Y. TIMES, July 19, 2011, at B1, B5.

wife I am sad to say) believe that when it comes to financial regulation, we need "more." Or, alternatively, that we should have "reform."

But to a working lawyer, "more" and "reform" are empty phrases. Might as well tell me that financial regulation requires more mom and apple pie, allowing us to have more chickens with our more pots, cars and garages.

At a slightly more sophisticated level, the public proponents might toss out a term like "transparency." Now "transparency" sounds weightier than simply "more," or even than "reform." So step back and I will let fly a bit.

The Government Needs More Information About Swaps

CFTC Chairman Gensler leads the public side of the debate about swaps. He has made the case for "transparency" as follows:

> The [Dodd-Frank] Act includes robust recordkeeping and reporting requirements for all swaps transactions. It is important that all swaps – both on-exchange and off – be reported to data repositories so that regulators can have a window into the risks posed in the system and can police the markets for fraud, manipulation and other abuses.[4]

At the level of complete and meaningless generality at which the public debate operates, I have no quarrel with Chairman Gensler. If it will be useful for the U.S. government to have more information about swaps so that it can do the job of financial regulation properly, I am happy for it. I don't have any philosophical objections, nor do I believe that there is some right of privacy with respect to financial instruments. Given that I am accustomed to working with closely-regulated financial entities, I assume that everything that I, or my clients, do or write is subject to the review of the government.

In fact, my concession is more abject than Chairman Gensler's demands. Chairman Gensler only wants information about "swaps." For myself, I am willing to concede that the government may require information as to every contract that is either (i) entered into in the United States or (ii) that is entered into outside the United States but could have an effect on the United States.

Suppose that, instead of only asking for swaps information, Dodd-Frank had said "any agency of the U.S. government may require any individual or entity doing business or having offices in the United States, or doing business outside the United States that may have an effect on the United States, to report such information on any contract into which it enters as any such U.S. agency may require, in such form and on such timing as

[4] Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n, Remarks on the OTC Derivatives Reform to the Economic and Monetary Affairs Committee in Brussels, Belgium (Mar. 22, 2011).

the agency requires, in the public interest." It would be ok with me. I am not a libertarian. I understand that there may be certain specific types of contracts protected by the First Amendment (such as who buys particular books), but that is a detail. Very few financial contracts, and no swaps, are protected in this regard.

Now, having said that I completely and utterly concede to Chairman Gensler in his desire to protect the economy, let me impose my few caveats (of reasonableness). (i) The cost of collection of the information by market participants and the transfer of that information to the government should be reasonable. (ii) The government should be able to make some reasonable use of that information, at a reasonable cost, and that cost should be reasonable in light of the other tasks of the government, given that the government does not have infinite resources.

Under the CFTC's proposed rules, firms entering into swaps regulated by the CFTC must report somewhere around 30 or 40 data items about the swap within 15 minutes of the trade.[5] Among these data items are whether (i) the swap is uncleared, which means that it will be subject to individually negotiated collateral terms, and (ii) whether the swap is "bespoke," which the CFTC defines as a term, not reported, that is "material" to the transaction.

Now, if either of these two boxes is checked, all the rest of the 30 or 40 data items of information reported to the CFTC are essentially worthless. Even if the two boxes are not checked, the other 30 or 40 fields of information are just too much data to be cheap to deliver, and too little data to be useful.

For example, let's say that the trade is a currency option on an Asian currency. The CFTC's data form provides for 8 fields of information about options, each of the 8 fields having multiple choices, including "other," meaning again that all of the collected information will be useless. Now, it so happens that one of the major risks with trading in Asian currencies is that the currency may become inconvertible. In that case, the parties may seek to get out of the trade, or they may be stuck with a trade or with currencies that they do not want to hold, and they will have to make arrangements to deal with this contingency. Without knowing how the parties dealt with the non-convertibility issue on an Asian currency swap (which is not one of the CFTC data items), all of this other information is useless.

[5] Highlighting the unrealistic nature of the 15 minute reporting requirement, when the Transaction Reporting and Compliance Engine system ("TRACE") was introduced, reporting took 75 minutes, and "reporting requirements for swaps are significantly more complex." *See* Kenneth E. Bentsen, Comment to the CFTC Regarding Real-Time Reporting and Swap Data Recordkeeping, International Swaps and Derivatives Association, Inc. 12 (Feb. 7, 2011).

Cost/Benefit

It is that way for pretty much everything that the CFTC wants to collect on swaps: too much information to be done cheaply; too little information to be useful.

Except that the CFTC says that this information collection effort is not expensive. In fact, the expense of collecting these 30 or 40 items of data (each of which has numerous possible choices and calculations) and reporting them to the regulators is so "minimal,"[6] that the CFTC says it is not even worth the bother of trying to determine the cost.

Really? That minimal?[7]

I, on the other hand, am not persuaded that the CFTC is making a serious effort to determine what the costs of obtaining this information will be, what the costs of using this information will be, and how useful this information will be to market participants.[8]

In the best of all Panglossian worlds where there was an infinite amount of money to be spent on financial regulation, both as to the costs of compliance by the regulated and as to the costs of regulation by the government, these questions of practicality and benefit would not matter. If the regulators adopt rules that don't work, it is just money down the drain; plenty more where that came from.

In the harsh MMA-world in which we actually live, where we are running up against the debt ceiling, where we know at some point the taxes are likely to go up, and government support payments are likely to go down, the way in which we spend our regulatory dollars does matter. There is a limited tonnage of these dollars. Money wasted collecting useless information about swaps is money that could be spent on something that better protects the economy or investors.

Moreover, wasteful regulation has other negatives. Building systems to comply with useless reporting regulations is expensive, driving small players out of the industry, reducing competition, worsening the problem of "too big to fail." Regulatory costs are

[6] *See* Reporting, Recordkeeping, and Daily Trading Records Requirements for Swap Dealers and Major Swap Participants, 75 Fed. Reg. 236, III(C) (proposed Dec. 9, 2010) (to be codified at 17 C.F.R. pt. 23).

[7] Problems arise with regards to both the amount of data collected and the recordkeeping form the data must be stored in. *See id.* at 32 (noting the difficulties in gathering data on pre-execution communications, up to the minute timestamps for quotations given or received before an execution, and swap portfolio reconciliations because "industry participants do not typically capture all this data"); *id.* at 31 (noting the significant costs associated with "aggregating transaction data from all systems into a single . . . file," maintaining records for five years after the life of a swap, and making real-time records instantly accessible given the large volume of transactions occurring each day).

[8] Failing to obtain, or making any serious effort to obtain, such a cost estimate seems contrary to President Obama's Executive Order 13,563. *See* Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 21, 2011) (requiring agencies to "propose or adopt a regulation only upon reasoned determination that its benefits justify its costs").

essentially a tax that must be paid by somebody, presumably at least in part by customers. In addition, bad or expensive regulations lose jobs, drives them overseas. Beyond that, bad and expensive regulations result in a reduction of respect for the government. It makes one feel that the government just can't act effectively, and I would very much like to believe that it can.

How to Do It Better

While I do not believe that any good can or will come out of Dodd-Frank, there are ways to make it less of a waste. Start with smaller regulations and test their effectiveness. It would be more reasonable to start with collecting monthly aggregate swaps data, as that would give a sense of the parameters and scope of the task of collecting individual trade data and give some guidance as to what individual trade data would be useful.

Or try a pilot program. Under Dodd-Frank, the CFTC has been collecting information on "pre-existing" pre-Dodd-Frank swaps for a considerable period. (I am curious if any benefit has come from this collection.) On the basis of this information, the CFTC could design a limited pilot program for reporting trade data on particular types of swaps: soybean swaps, hurricane swaps, an EU sovereign swap, a Ringgit swap. Then the results of the pilot program could be published. Maybe a sequence of transaction information could be released gradually through a week of trading days, just as the CFTC imagines its system will work. That would give market participants (buy- and sell-side) and economists a chance to analyze the information and see whether it is of any use and would also allow a better opportunity to analyze costs.

If the tests in a pilot program show that all of this information the CFTC wants to collect about swaps is useful and cost-effective, I have no objection. We will have waited an additional few months for our data on soybean swaps, but I suspect that the economy can survive that. The risk to the financial regulatory system of building a useless information trash receptor seems greater to me than the risk of delay, test and evaluate.

Lastly, understand I just picked the topic of trade reporting because it is fairly simple. The statute is 2,000 pages, and more than a problem per page.