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Minding the Gap: A Call for Standardizing Pre-dispute Arbitration Clauses in OTC Derivative Transactions

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Following the 2008 financial market collapse, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act, splitting jurisdiction over OTC swaps between the SEC and the CFTC. Each agency takes a different approach to regulating the use of pre-dispute arbitration clauses in OTC swap agreements. Although both approaches designedly protect investors who mistakenly waive their right to litigation when buying OTC swaps, neither addresses the economic realities inherent in these transactions. Consequently, the current scheme overregulates investors, impinges on the competitiveness of the OTC swap market, and contradicts the policies underlying Dodd-Frank. This note contends that a limited, prescriptive-based approach should be taken to adequately respond to these concerns. Moreover, the agencies should look to the ISDA for assistance in facilitating compliance with these newly enacted rules.

I. INTRODUCTION: A PLEA FOR ACTION

Wall Street quakes and the financial markets tremble when disgruntled investors reeling from deals gone bad threaten class action litigation against financial giants like JPMorgan Chase.[1] These resonating fears are not unfounded; class action suits remain prevalent in banking litigation and are expected to proliferate in the years to come.[2] Investment firms selling financial products attempt to mitigate seismic damage by including pre-dispute arbitration clauses in new-client agreements.[3] Following the 2008 market collapse, the practice of using these clauses began attracting scrutiny and severe criticism by investors and advocacy groups alike, as investment firms became increasingly aggressive in requiring mandatory arbitration

1. *See* Susan Antilla, *Schwab Case Casts Spotlight on Securities Arbitration and Its Flaws*, N.Y. Times, Sept. 5, 2013, at B5, *available at* http://dealbook.nytimes.com/2013/09/04/schwab-case-casts-spotlight-on-securities-arbitration-and-its-flaws/.

2. *See generally* Baker Hostetler, 2012 Year-End Review of Class Actions (2013), *available at* http://www.bakerlaw.com/files/Uploads/Documents/News/Alerts/Litigation/2013/Class-Action-Year-End-Review.pdf.

> Another potential trend to keep an eye on is the development of class action litigation relating to the [London Interbank Offered Rate] rate-fixing scandal, which has the potential to impact trillions of dollars of financial transactions worldwide and could be a catalyst to the accelerated expansion of class and collective action procedures in other parts of the world.

Id. at 44.

3. A "pre-dispute arbitration clause" is broadly defined as an agreement between a firm and its client stating that the parties agree to subject future disagreements to arbitration. Modern financial transaction agreements use arbitration clauses that include express class action waivers, which prevent the parties from litigating disputes through a class action. *See, e.g.*, Am. Express Co. v. Italian Colors Rest., 133 S. Ct. 2304 (2013). For ease of analysis, this note's use of "pre-dispute arbitration clause" includes a clause that waives class action suits. Similarly, this note's use of "financial product" refers to any product purchased with the expectation of earning a favorable return, unless otherwise indicated. For a full discussion of class action litigation under Rule 23 of the Federal Rules of Civil Procedure, see David Marcus, *The History of the Modern Class Action, Part I: Sturm Und Drang, 1953–1980*, 90 Wash. U. L. Rev. 587 (2013).

when negotiating new contracts.[4] The "take it or leave it" approach requiring pre-dispute arbitration clauses inflicts potential harm on unsophisticated investors who cooperatively sign their agreements without fully understanding the repercussions of inadvertently waiving their right to litigate disputes.[5] The core of this issue arises from the traditional tensions of fairness, efficiency, cost, and neutrality when comparing arbitration to litigation.[6] Investor advocates condemn mandatory arbitration as being "unfair, inefficient, expensive, and biased."[7] These critics argue that "the selected arbitrators do not have to follow the law, rarely permit depositions and typically do not award punitive damages."[8] Firms, of course, support the arbitration process for the exact opposite reasons, arguing it is more effective, efficient, fair, and far less expensive.[9] Proponents argue that arbitration is faster, and therefore cheaper, due to its limited motion practice and narrowly tailored discovery.[10] Nonetheless, depending on the financial product in question, recent trends indicate that both sides to a nonexchange-traded transaction prefer to include mandatory arbitration language in their agreements.[11]

In response to the criticisms of mandatory arbitration, § 921 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") granted rulemaking authority to the U.S. Securities and Exchange Commission (SEC), empowering it to restrict the use of mandatory arbitration clauses in broker-dealer and investment adviser contracts.[12] Supporters of litigation remedies (i.e., class

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4. *See* Antilla, *supra* note 1.

5. *Id.*

6. Jill I. Gross, *The End of Mandatory Securities Arbitration?*, 30 Pace L. Rev. 1174, 1179 (2010).

7. *Id.*

8. *See* Antilla, *supra* note 1.

9. Gross, *supra* note 6.

10. *See generally* Sec. Indus. & Fin. Mkt. Ass'n, White Paper on Arbitration in the Securities Industry (Oct. 2007), *available at* http://www.sifma.org/uploadedfiles/societies/sifma_compliance_and_legal_society/whitepaperonarbitration-october2007.pdf.

11. *See* International Swaps and Derivatives Association (ISDA) discussion *infra* Part II.C.3.

12. The provision reads as follows:

> SEC. 921 AUTHORITY TO RESTRICT MANDATORY PRE-DISPUTE ARBITRATION.
>
> (a) Amendment to Securities Exchange Act of 1934.—Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o), as amended by this title, is further amended by adding at the end of the following new subsection:
>
> "(o) Authority to Restrict Mandatory Pre-dispute Arbitration.—The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."

actions) chide the SEC for failing to exercise this power in a timely manner.[13] To address the SEC's inaction, the Investor Choice Act of 2013 was introduced in Congress on August 2, 2013.[14] If enacted, the bill will prohibit broker-dealers[15] from imposing mandatory pre-dispute arbitration agreements when selling securities-based derivatives.

Ironically, regulations governing futures-based exchange-traded derivatives have prohibited the use of mandatory pre-dispute arbitration clauses since the early 2000s.[16] The National Futures Association (NFA)[17] is reluctant to enforce mandatory pre-dispute arbitration agreements due, at least in part, to the practice's contravention of "prevailing law and policy regarding dispute resolution procedures."[18] Thus, customers doing business with firms registered with the U.S. Commodity Futures Trading

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> (b) Amendment to Investment Advisers Act of 1940.—Section 205 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-5) is amended by adding at the end the following new subsection:
>
> . . . .
>
> "(f) Authority to Restrict Mandatory Pre-dispute Arbitration.—The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any investment adviser to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors."

Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank] (codified as amended in scattered sections of U.S.C. titles 7, 12, 15, and 31). The U.S. Commodity Futures Trading Commission (CFTC), on the other hand, was not granted such rulemaking authority. *See id.*

13. *See* Antilla, *supra* note 1.

14. Investor Choice Act of 2013, H.R. 2998, 113th Cong., *available at* https://www.govtrack.us/congress/bills/113/hr2998/text.

15. A "broker" is generally defined as "any person engaged in the business of effecting transactions in securities for the account of others." Exchange Act of 1934, ch. 404, § 3(a)(4)(A), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78c(a)(4)(A) (2013)). A "dealer" is generally defined as "any person engaged in the business of buying and selling securities . . . for such person's own account through a broker or otherwise." Exchange Act of 1934 § 3(a)(5)(A) (codified as amended at 15 U.S.C. § 78c(a)(5)(A) (2013)). Most brokers and dealers must register with the Securities Exchange Commission (SEC). Exchange Act of 1934 § 15 (codified as amended at 15 U.S.C. § 78o).

16. *See* 17 C.F.R. § 166.5(b) (2014); Nat'l Futures Ass'n, Code of Arbitration § 3 [hereinafter Code of Arbitration], *available at* https://www.nfa.futures.org/nfamanual/NFAManual.aspx?Section=5; A New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 42256-01 (Aug. 10, 2001).

17. "[The] National Futures Association (NFA) is the industrywide, self-regulatory organization for the U.S. derivatives industry. [The] NFA strives every day to safeguard market integrity, protect investors and help our Members meet their regulatory responsibilities." Nat'l Futures Ass'n, http://www.nfa.futures.org (last visited Apr. 25, 2015).

18. New Regulatory Framework for Trading Facilities, Intermediaries and Clearing Organizations, 66 Fed. Reg. 42,256 (Aug. 10, 2001); *see also* Code of Arbitration, *supra* note 16, § 1; SRO discussion *infra* Part II.C.2.

Commission (CFTC)[19] will have different rights available for settling disputes than customers transacting with SEC registrants.

An added layer of complexity emerges for customers investing in over-the-counter swaps ("OTC swaps").[20] Although Dodd-Frank overhauled the regulatory landscape for firms dealing in OTC swaps, it did not grant rulemaking authority over the use of mandatory pre-dispute arbitration clauses in OTC swap transactions.[21] Nonetheless, the 2013 ISDA Arbitration Guide[22] (the "Guide") published on September 9, 2013 by the International Swaps and Derivatives Association (ISDA)—a trade organization for OTC swap market participants—provides some guidance in regulating their use. Unlike U.S.-based OTC swaps, counterparties to an international OTC swap transaction regularly incorporate pre-dispute arbitration clauses in their agreements and many of them rely upon the Guide for direction.[23] The Guide provides model arbitration clauses to be used in conjunction with standard form contracts provided to market participants by the ISDA.[24] Each of these clauses includes language mandating that any dispute arising from the transaction shall be resolved through arbitration.[25] However, the Guide carries no authoritative weight in the United States,[26] leaving the dispute settlement rights associated with U.S.-based OTC swap transactions murky and unclear.

19. A "Futures Commission Merchant," for example, is an individual or organization which both solicits or accepts orders to buy or sell futures contracts, options on futures, retail off-exchange forex contracts, or swaps, and accepts money or other assets to support such orders. These entities are typically required to register with the NFA, the self-regulatory organization (SRO) of the CFTC. *Futures Commission Merchant (FCM)*, Nat'l Futures Ass'n, http://www.nfa.futures.org/%5C/%5C/NFA-registration/fcm/index.html (last visited Apr. 25, 2015).

20. An "over-the-counter swap" (OTC swap) is a bilateral agreement between various counterparties that assume credit exposure of the instrument. The terms of an OTC swap, including the product's margining, are customizable to meet the needs of the contracting parties. *Product Descriptions and Frequently Asked Questions*, Int'l Swaps & Derivatives Ass'n, http://www.isda.org/educat/faqs.html#3 (last visited Apr. 25, 2015) [hereinafter ISDA FAQ]. But see the discussion *infra* Part II.C.3 regarding new margin requirements for OTC swaps. In 2012, the OTC swap market was estimated to be worth a total of $708 trillion. Sarah N. Lynch, *U.S. Senate Panel OKs Budget Boosts for SEC, CFTC*, Reuters (June 14, 2012, 3:51 PM), http://www.reuters.com/article/2012/06/14/us-senate-cftc-sec-funding-idUSBRE85D1HJ20120614.

21. *See* Dodd-Frank, Pub. L. No. 111-203, § 722, 124 Stat. 1376 (2010) (codified as amended at 7 U.S.C. § 2 (2013)).

22. Int'l Swaps & Derivatives Ass'n, 2013 ISDA Arbitration Guide (2013) [hereinafter 2013 ISDA Arbitration Guide], *available at* http://www2.isda.org/attachment/NTg0MQ==/ISDA_Arbitration_Guide_Final_09.09.13.pdf.

23. *See* ISDA discussion *infra* Part II.C.3.

24. *Id.*

25. *Id.*

26. *See, e.g.*, Int'l Swaps & Derivatives Ass'n, ISDA Outlines Approach on Cross-Border Issues: Principles Address Inter-jurisdictional Recognition of Derivatives Regulation (Aug. 20, 2013), *available at* http://www2.isda.org/news/isda-outlines-approach-on-cross-border-issues-principles-address-inter-jurisdictional-recognition-of-derivatives-regulation (indicating that ISDA principles merely serve as a guide to develop "frameworks and processes for inter-jurisdictional recognition of derivatives regulation").

This note discusses the current regime regulating the use of mandatory pre-dispute arbitration clauses in OTC swap transactions governed by the SEC and CFTC, exposing current flaws in the system. It then demonstrates that a "one size fits all" approach to regulating the use of these clauses is unworkable and impractical in the context of OTC swaps. A bright-line rule does not accurately reflect the needs of each counterparty and fails to address the power distributions inherent in these transactions. Instead, this note suggests that a balanced prescriptive-based approach is necessary to adequately protect investors while simultaneously maintaining the competitiveness of the OTC swap market.

Part II discusses the history leading up to the current use of pre-dispute arbitration clauses in the dealing of complex financial products. It examines the divergent views taken by the SEC, CFTC, and ISDA in shaping the use and legality of these clauses. Importantly, Part II demonstrates that these different approaches have arbitrarily compartmentalized segments of the OTC market without a visibly rational basis for doing so. Part III focuses on the "fairness" aspect of mandatory arbitration to exploit the complications associated with the arbitrary jurisdictional divide between the SEC and CFTC. It applies various theories of negotiating power to demonstrate that, both economically and pragmatically, a "one size fits all" approach to regulation is unworkable. Part IV suggests that certain regulations already enacted under Dodd-Frank's framework sufficiently protect a large segment of the OTC swap market. For those market participants excluded from this protection, Part IV proposes a two-phase approach to standardizing the regulation of pre-dispute arbitration clauses in the U.S. OTC swap market. Cooperation among the SEC, CFTC, and ISDA to implement this approach will, in turn, further the various policies upon which Dodd-Frank is based.

II. HISTORY: TRACING AN EMERGING CONFLICT

A. Overview of Derivatives Regulation in the United States

Fragmented regulation besets the financial markets in the United States.[27] On the one hand, securities and options on securities are governed by the SEC.[28] Futures and options on futures, on the other hand, are regulated by the CFTC.[29] Until recently, OTC swaps—which comprise such financial products as off-exchange-

27. The United States is unlike many other countries because of its dual regulatory regime. The following markets have only one regulator for their entire financial system: Austria, Bahrain, Belgium, Cayman Islands, Czech Republic, Denmark, Estonia, Finland, Germany, Gibraltar, Hungary, Iceland, Ireland, Japan, Kazakhstan, Latvia, Maldives, Malta, Nicaragua, Norway, Poland, Singapore, South Korea, Switzerland, Sweden, Taiwan, and the United Arab Emirates. *See* Elizabeth F. Brown, *A Comparison of the Handling of the Financial Crisis in the United States, the United Kingdom, and Australia*, 55 Vill. L. Rev. 509, 512 n.13 (2010). Although much of the discussion following the financial crisis has criticized the dual regulatory model, none of it has generated movement to change the model employed by the United States. *See id.* at 511–12

28. Dodd-Frank, Pub. L. No. 111-203, § 722, 124 Stat. 1376 (2010) (codified as amended at 7 U.S.C. § 2(a)(1) (2013).

29. *Id.* § 2(a)(1)(A).

traded forward contracts, options, and swaps—were highly unregulated.[30] Dodd-Frank addressed unregulated OTC swaps by imposing a divided jurisdiction over those products between the SEC and CFTC (together the "Commissions").[31] Each agency's jurisdiction depends on the type of OTC swap transaction in dispute. The SEC governs security-based swap transactions,[32] and the CFTC oversees all other OTC swap transactions.[33] The Commissions share authority over mixed swap transactions.[34] Although Dodd-Frank empowers the Commissions with joint rulemaking authority for mixed swaps, they have yet to exercise their power.[35] One

30. *See* Commodities Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended at 7 U.S.C. §§ 1–27(f) (2013)); *see also* Donald N. Lamson & Hilary Allen, *SEC and CFTC Joint Rulemakings Under Dodd-Frank—A Regulatory Odd Couple?*, 43 Sec. Reg. & L. Rep. 495, 496 (2011), *available at* http://www.shearman.com/~/media/Files/NewsInsights/Publications/2011/03/SEC%20and%20CFTC%20Joint%20Rulemakings%20Under%20DoddFrankA%20__/Files/View%20full%20article%20SEC%20and%20CFTC%20Joint%20Rulemakings__/FileAttachment/AT031011SecuritiesRegulationLawLamsonandAllenPub__.PDF.

> Over time, the increasing size of the swaps markets continued to draw Congressional and regulatory scrutiny, but Congress confirmed its endorsement of the indirect regulation model. In 2000, rather than divide jurisdiction over swaps between interested regulators, the CFMA excluded bilaterally traded swaps between sophisticated parties from regulatory oversight. The exclusion was based on the belief that most swaps were not susceptible to manipulation and most swap counterparties were sophisticated participants who did not require regulatory protection in what functioned as a *wholesale* market.

Id.

31. *Derivatives*, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/spotlight/dodd-frank/derivatives.shtml (last modified Feb. 12, 2015). The conflicting cultures of the SEC and CFTC heighten the problems associated with this split in jurisdiction. Both agencies interpret and apply rules differently and are divergent in their approach to regulating financial products. The SEC tends to employ a more rules-based approach, while the CFTC uses a principles-based approach. *See* U.S. Dep't of the Treasury, Financial Regulatory Reform: A New Foundation 50 (2009).

32. Generally, swaps are financial products "based on interest or other monetary rates," whereas security-based swaps are financial products "based on the yield or value of a single security, loan, or narrow-based security index." Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed-Swaps; Security-Based Swap Agreement Recordkeeping, 17 Fed. Reg. 48,207, at 48,262 (Aug. 13, 2012) (codified at 17 C.F.R. § 230, 240, and 241 (2014)).

33. *See* discussion *infra* Part III.A.

34. *Id.*

35. Although this rulemaking has yet to occur, the CFTC has provided the following explanation:

> In order to facilitate the trading of these instruments in appropriate circumstances, the proposed rules provide that bilateral, uncleared mixed swaps, where one of the counterparties is dually registered as a dealer or major participant with both the CFTC and also with the SEC, would be subject to certain key provisions of the [Commodity Exchange Act (CEA)] and related CFTC rules as well as the requirements of the federal securities laws. For all other mixed swaps, the Commissions are proposing a process where a person who desires or intends to list, trade, or clear such a mixed swap (or class thereof) can ask the agencies for a joint order permitting the requesting person (and any other person or persons that subsequently lists, trades, or clears that mixed swap) to comply, as to parallel provisions only, with specified parallel provisions of either the CEA or the Securities Exchange Act of 1934 ("Exchange Act"), and the rules and regulations under the relevant statute, rather than being required to comply with parallel provisions of both the CEA and the Exchange Act.

commentator has suggested that the regulatory marinade slowing this financial reform is due, at least in part, to the battle over the amount of funding that should be appropriated to these agencies.[36] This jurisdictional split has caused uncertainty over which agency's rules apply to which financial products. It comes as no surprise that this uncertainty blooms when SEC and CFTC rules—that could arguably apply to the same financial product—conflict. This is precisely the problem emerging in the Commissions' regulation of pre-dispute arbitration clauses. This nascent clash could have widespread, adverse repercussions not only for firms transacting in the United States, but also across the global financial markets.

B. Overview of U.S. Arbitration: The Federal Arbitration Act

Before 1925, a party could enter into a pre-dispute arbitration agreement, and then decline to honor it once a dispute arose, irrespective of the substance of the transaction.[37] This caused more congestion in the courts and greater litigation costs. In response, Congress passed the United States Arbitration Act,[38] which later became known as the Federal Arbitration Act (the "Act"). Among other things, the Act made arbitration clauses in commercial contracts "valid, irrevocable, and enforceable."[39] In essence, the Act was only intended to make voluntary arbitration agreements between merchants enforceable—not to validate arbitration clauses in adhesion contracts.[40] The Act aimed to preempt litigation in favor of a faster, less expensive arbitration proceeding.[41]

Commodity Futures Trading Comm'n, Q & A—Final Rules and Interpretations i) Further Defining "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; ii) Regarding "Mixed Swaps"; and, iii) Governing Books and Records for "Security-Based Swap Agreements" 4 (2012) [hereinafter CFTC Q&A], *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/fd_qa_final.pdf.

36. Lynch, *supra* note 20.

37. Rhonda Wasserman, *Legal Process in a Box, or What Class Action Waivers Teach Us About Law-Making*, 44 Loy. U. Chi. L.J. 391, 394–95 (2012).

38. Federal Arbitration Act, Pub. L. No. 68-401, 43 Stat. 883 (1925) (codified as amended at 9 U.S.C. §§ 1–14 (2013)).

39. *Id.* § 2 (codified as amended at 9 U.S.C. § 2).

40. Margaret L. Moses, *Statutory Misconstruction: How the Supreme Court Created a Federal Arbitration Law Never Enacted by Congress*, 34 Fla. St. U. L. Rev. 99, 107 (2006).

41. Catherine Moore, *The Effect of the Dodd-Frank Act on Arbitration Agreements: A Proposal for Consumer Choice*, 12 Pepp. Disp. Res. L.J. 503, 506 (2012) (citing Jon O. Shimabukuro, *The Federal Arbitration Act: Background and Recent Developments*, CRS Rep. Congress 1 (Aug. 15, 2003)). For recent litigation involving the Federal Arbitration Act, see *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 559 U.S. 662, 687 (2010) (holding that parties with a contract silent on the issue of class-wide arbitration "cannot be compelled to submit their dispute to class arbitration"), and *AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1756 (2011) (holding that the Federal Arbitration Act preempts a state rule treating class action waivers in adhesion contracts as unconscionable).

Until 1953, financial product contracts incorporating pre-dispute arbitration agreements were regularly enforced.[42] Then the U.S. Supreme Court held, in *Wilko v. Swan*, that pre-dispute clauses could not be used to compel investors to resolve their claims through arbitration.[43] The Court emphasized that the right to select a judicial forum cannot be waived, and any such agreement is invalid.[44] Comparatively, *Wilko* gutted the more flexible and streamlined approach to resolving disputes envisioned by the Act's drafters.

C. *Overview of Arbitration in Derivative Transactions*

1. *Securities-Based Exchange-Traded Derivatives*

The SEC is marshaled by the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization (SRO).[45] In 1973, the National Association of Securities Dealers (NASD),[46] which is now part of FINRA, adopted the NASD Code of Arbitration ("the Code"), which governs securities arbitration.[47] Section 12 of the Code prohibits financial firms from compelling clients to arbitrate through pre-dispute agreements.[48] Instead, investors may freely choose between arbitration and litigation in the event of a dispute. Continuing this trend, in 1979 the SEC notified firms that requiring arbitration without adequate disclosure would violate the covenant of good faith and fair dealing.[49] At this point, the judiciary and regulators had

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42. Moore, *supra* note 41, at 507.

43. 346 U.S. 427, 438 (1953). The Court concluded that an agreement to arbitrate is a "stipulation," and the right to select this type of forum cannot be waived under § 14 of the Securities Act of 1933. *Id.* at 434–35. Instead, the Court determined that Congress must have intended § 14 "to apply to a waiver of judicial trial and review." *Id.* at 437.

44. *Id.*

45. *See generally* U.S. Sec. & Exch. Comm., The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, *available at* http://www.sec.gov/about/whatwedo.shtml (last visited Apr. 25, 2015).

46. "The [National Association of Securities Dealers (NASD)] is the leading private sector regulator of America's securities industry and operates the largest securities dispute resolution forum in the world, and handles ninety percent of security industry arbitrations and mediations in the United States." Matthew Eisler, *Difficult, Duplicative and Wasteful?: The NASD's Prohibition of Class Action Arbitration in the Post-Bazzle Era*, 28 Cardozo L. Rev. 1891, 1891 n.2 (2007).

47. *See generally id.*; *see also* Moore, *supra* note 41, at 508; Fin. Indus. Regulatory Auth., Code of Arbitration Procedure, *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4033&record_id=11676&filtered_tag= (last visited Apr. 25, 2015).

48. Moore, *supra* note 41, at 508–09. Today, this rule exists as Financial Industry Regulatory Authority (FINRA) Rule 12200. Fin. Indus. Regulatory Auth., Code of Arbitration Procedure for Customer Disputes, *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4096&record_id=5174&filtered_tag= (last visited Apr. 25, 2015).

49. Moore, *supra* note 41, at 508 (citing Notice to Broker-Dealers Concerning Clauses in Customer Agreements Which Provide for Arbitration of Future Disputes, Exchange Act Release No. 15,984, 17 SEC Docket 1167, at *4 (July 2, 1979) ("[I]n 1983 the Exchange Act Rule 15c2-2 was adopted to address [the inclusion of] pre-dispute arbitration agreements in customer brokerage agreements. These

seemingly closed the door on mandatory arbitration clauses in securities transactions, including securities-based exchange-traded derivatives.

It wasn't until 1987 that the door was reopened. In *Shearson/American Express v. McMahon*[50] and *Rodriguez de Quijas v. Shearson/American Express, Inc.*,[51] the U.S. Supreme Court reversed *Wilko* and held that claims arising under both the Securities Exchange Act of 1934 (the "Exchange Act") and the Securities Act of 1933[52] are arbitrable.[53] The Court determined that the earlier concerns over the inadequacy of arbitration to protect investors' rights, as articulated in *Wilko*, were no longer relevant for arbitration proceedings. This was due, at least in part, to the SEC's interim changes to the regulatory structure of the securities laws.[54] When read together, these decisions meant that pre-dispute agreements to arbitrate claims arising under the securities laws were enforceable.[55] As a result, firms could now force consumers into arbitration by insisting upon pre-dispute arbitration agreements.

In the wake of these decisions, the SEC took the position that banning mandatory arbitration clauses was, absent express legislation, beyond its power.[56] In 2010, Congress enacted legislation to address the SEC's position: Section 921 of Dodd-Frank grants the SEC power to decide how mandatory arbitration claims are resolved in securities disputes.[57] Specifically, the legislation amended both the Exchange Act and the Investment Advisers Act of 1940 to allow the SEC "to prohibit or limit the use of arbitration agreements used by brokers, dealers, or securities traders that arise under the federal securities laws or the rules of a self-regulatory organization—such as FINRA—if such conditions are in the public interest and for the protection of investors."[58]

However, the SEC never exercised this rulemaking authority.[59] In 2011, a flurry of criticism was unleashed rebuking the SEC for its failure to act.[60] The brokerage firm Charles Schwab & Company ("Schwab") triggered the torrent of criticism when it unilaterally amended its account agreements to include a provision forcing nearly seven million clients to waive their rights to bring class actions against the firm—an option that was previously available to even those who had agreed to mandatory pre-

measures meant that when arbitration agreements were included in a securities agreement, customers had to be made aware of this fact and potential consequences.")).

50. 482 U.S. 220 (1987).

51. 490 U.S. 477 (1989).

52. Moore, *supra* note 41, at 510–11.

53. Gross, *supra* note 6, at 1184.

54. *McMahon*, 482 U.S. at 233–34; *Rodriguez*, 490 U.S. at 480–83.

55. *McMahon*, 482 U.S. at 238; *Rodriguez*, 490 U.S. at 483–85.

56. Gross, *supra* note 6, at 1184.

57. *See generally* Moore, *supra* note 41.

58. *Id.* at 515.

59. *See* Antilla, *supra* note 1.

60. *Id.*

dispute arbitration clauses.[61] FINRA's enforcement division filed a disciplinary action against Schwab shortly thereafter,[62] asserting that Schwab's class action waiver violated both NASD and FINRA rules.[63] After losing "its enforcement action against Schwab when an in-house hearing panel dismissed the regulator's claim," FINRA appealed to the National Adjudicatory Council.[64] Before the appeal was concluded, FINRA's Board of Governors reversed the hearing panel decision.[65] Then, in April 2014, FINRA won its battle to prohibit Schwab from requiring a class action waiver.[66]

Still, critics argue that the SEC has largely disregarded Dodd-Frank's mandate to decide how mandatory arbitration clauses are to be resolved in securities disputes. In a letter addressed to SEC Chair Mary Jo White,[67] Senator Al Franken wrote: "The time is ripe for the Commission to act to protect the investing public and prevent further abuse of forced arbitration contracts."[68] Following this lambasting, House Financial Services Committee Representative Keith Ellison introduced the Investor Choice Act of 2013, which seeks to amend § 921 of Dodd-Frank to statutorily "prohibit the use of mandatory pre-dispute agreements in broker-dealer and investment adviser customer contracts that restrict investors' ability to pursue claims in the lawful forum of their choosing."[69] Although the bill was referred to committee, its chance of becoming law remains slim to this day.[70]

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61. *Finra Charges Charles Schwab & Co. with Violating Finra Rules by Using Class Action Waiver in Customer Agreements*, Fin. Indus. Regulatory Auth. (Feb. 1, 2012), http://www.finra.org/Newsroom/NewsReleases/2012/P125517.

62. Antilla, *supra* note 1.

63. *See* Complaint and Request for Expedited Hearing at 8, Dep't of Enforcement v. Charles Schwab & Co., Fin. Indus. Regulatory Auth. Disciplinary Proceeding No. 2011029760201, (Feb. 1, 2012), *available at* http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p125516.pdf. Charles Schwab & Company ("Schwab") challenged FINRA's decision, won at a panel hearing on February 21, 2013, and FINRA subsequently appealed. Antilla, *supra* note 1.

64. Matthias Rieker, *Finra Wins Appeal in Schwab Class-Action Dispute*, Wall St. J. (last updated April 24, 2014), http://online.wsj.com/articles/SB10001424052702303380004579522093469025968.

65. *Id.*

66. *Id.* "Lawyers had said [that] Schwab's attempt to prevent class-actions could have set a precedent for other brokers to put similar clauses into their customer agreements, which have the potential to hurt investors who are less likely to go through costly arbitration over small losses from unsuitable investments." *Id.*

67. *Sen. Franken Leads Charge to Protect Consumers' Legal Rights Against Wall Street*, Al Franken U.S. Sen. for Minn. (Apr. 30, 2013), http://www.franken.senate.gov/?p=press_release&id=2381.

68. *Id.*

69. *NASAA Strongly Supports the Investor Choice Act of 2013*, N. Am. Sec. Adm'rs Ass'n (Aug. 2, 2013), http://www.nasaa.org/25252/nasaa-strongly-supports-the-investor-choice-act-of-2013/; Investor Choice Act of 2013, H.R. 2998, 113th Cong. "Similar bills introduced in the Senate in earlier years have been unsuccessful. The Arbitration Fairness Act of 2007 (S. 1782), reintroduced as The Arbitration Fairness Act of 2009 (S. 931) both died in committee. An earlier House bill, The Arbitration Fairness Act of 2009 (H.R. 1020), met a similar fate." *Three Years After Dodd Frank, No SEC Action in Sight on Mandatory Securities Arbitration*, PRWeb (Aug. 31, 2013), http://www.prweb.com/releases/InvestorChoiceAct/2013/prweb11081501.htm.

70. *See H.R. 2998 (113th): Investor Choice Act of 2013*, GovTrack, https://www.govtrack.us/congress/bills/113/hr2998 (last visited Apr. 25, 2015).

2. *Commodities-Based Exchange-Traded Derivatives*

Less controversy has surrounded the use of mandatory pre-dispute arbitration clauses on the commodities side of the industry.[71] The CFTC has taken the unequivocal position that a firm cannot decline to open a futures account if a client refuses to sign a pre-dispute arbitration agreement.[72] In the event that a customer voluntarily signs such an agreement, however, the CFTC requires that "the agreement include a notice that the customer agrees to forgo private litigation but will still have a forty-five-day window in which to elect a reparations proceeding."[73] Moreover, institutional customers may enter such agreements and waive the right to bring a private reparations claim against a firm.[74] Although the CFTC—in response to a directive from Congress—considered whether it should include class actions in the reparations forum, it ultimately decided against this expansion.[75] When compared to the SEC, the CFTC's approach is a step in the right direction in that it carves out greater leeway for institutional customers—who presumably carry more bargaining power—to waive their right to litigation.[76] But as the discussion below suggests, the CFTC still falls short of the target.

The NFA, the futures industry SRO established under the Commodity Exchange Act (CEA), takes the position that properly executed pre-dispute arbitration agreements are binding.[77] However, a client is not otherwise required to arbitrate.[78] To be enforceable, the pre-dispute arbitration agreement must comply with Commission Rule 166.5, which requires such agreements to be entered into voluntarily.[79]

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71. This could be, in part, because arbitration is used less for resolving disputes involving commodity-based derivatives. *See, e.g.*, *Arbitration Statistics*, Nat'l Futures Ass'n, https://www.nfa.futures.org/nfa-arbitration-mediation/arbitration-statistics.html (last visited Apr. 25, 2015).

72. *See* 17 C.F.R. § 166.5(c)(1) (2014).

73. Verity Winship, *Public Agencies and Investor Compensation: Examples from the SEC and CFTC*, 61 Admin. L. Rev. 137, 149 (2009).

74. *See* 7 U.S.C. § 18(g) (2013) ("Nothing in this section prohibits a registered futures commission merchant from requiring a customer that is an eligible contract participant, as a condition to the commission merchant's conducting a transaction for the customer, to enter into an agreement waiving the right to file a claim under this section."). Indeed, such a condition precedent subjects the consumer to the same risks that are discussed throughout this note. These include, among other things, the inability to effectively negotiate for other provisions in the governing agreement. *See* power distribution discussion *infra* Part III.B.

75. Winship, *supra* note 73, at 150. This decision was issued in response to the agency's request for comments "on the appropriateness of class actions in reparations proceedings." *Id.* at 150 n.84. Other expansions have also been rejected "because of the need to keep the program simple." *Id.* at 150.

76. *See* Best Alternative to a Negotiated Agreement (BATNA) discussion *infra* Part III.B.

77. *See* Code of Arbitration, *supra* note 16; Commodity Exchange Act, 7 U.S.C. § 1–27f (2013); *see also* Nat'l Futures Ass'n, NFA Arbitration: Customer Arbitration Guide, *available at* http://www.nfa.futures.org/nfa-arbitration-mediation/publications/customer-arbitration-guide.pdf (last visited Apr. 25, 2015).

78. The NFA's mandatory arbitration provisions refer to the firms that are required to arbitrate. *Id.*

79. Code of Arbitration, *supra* note 16, § 1; *see also* 17 C.F.R. § 166.5(b) (2014) ("*Voluntariness.* The use by customers of dispute settlement procedures shall be voluntary . . . .").

3. *OTC Derivatives*

The $693 trillion OTC derivatives market[80] provides a flexible venue to transact in customizable contracts for hedging risk and taking positions on future price movements. The key provisions of Dodd-Frank's Title VII—including clearing, trading, capital, margining, reporting, and recordkeeping[81]—will fundamentally alter the OTC derivatives market forever. CFTC Chairman Gary Gensler once opined that:

> The Wall Street reform bill will—for the first time—bring comprehensive regulation to the swaps marketplace. Swap dealers will be subject to robust oversight. Standardized derivatives will be required to trade on open platforms and be submitted for clearing to central counterparties. The Commission looks forward to implementing the Dodd-Frank bill to lower risk, promote transparency and protect the American public.[82]

As discussed above, these provisions divide regulatory authority between the SEC and CFTC.[83] The SEC has authority over security-based swaps and the CFTC has authority over all other swaps.[84] Both the SEC and CFTC have jurisdiction over mixed swaps, but neither has issued rules exercising this jurisdiction, most notably in regard to the legality of pre-dispute arbitration clauses.[85]

Prior to the financial crisis, market participants responded to the lack of regulation and the risks surrounding OTC derivatives by establishing various private governance models.[86] One such response was to found the ISDA, which is composed of 800 member institutions from sixty-seven countries[87] and is the worldwide leader in

80. *See* Int'l Swaps & Derivatives Ass'n, The Value of Derivatives 6 (2014), *available at* https://www2.isda.org/attachment/NjQ3Mw==/ISDA%20FINAL%202014.pdf.

81. *See generally* Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

82. *Dodd-Frank Act*, Commodity Futures Trading Comm'n, http://www.cftc.gov/lawregulation/doddfrankact/index.htm (last visited Apr. 25, 2015).

83. The joint rulemaking authority granted to the SEC and CFTC by Dodd-Frank was largely in response to conflicting views on how to harmonize these two agencies. The George W. Bush administration proposed to merge the regulatory philosophies of the two agencies, with the CFTC's principles-based approach overriding the SEC's rules-based approach. *See* Dep't of the Treasury, Blueprint for a Modernized Financial Regulatory Structure (Mar. 2008), *available at* http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf. Conversely, the Barack Obama administration's policy insisted that the Commissions maintain their current market regulator roles, but also that the regulatory frameworks for futures and securities be harmonized. Lamson & Allen, *supra* note 30, at 497.

84. Dodd-Frank § 2(a)(1).

85. *Id.*

86. *See, e.g.*, *About ISDA*, Int'l Swaps & Derivatives Ass'n, http://www2.isda.org/about-isda (last visited Apr. 25, 2015).

87. *Id.*

> "These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers."

advancing "the understanding and treatment of derivatives as a risk management tool."[88] The ISDA is the primary trade and lobbying group for the international derivatives industry, and supplies standard form contracts that are used in many derivative transactions.[89] The Guide published by the ISDA in 2013 included a range of model clauses for various forms of arbitration for use in OTC derivative transactions.[90] These clauses complement the standard form contracts and provide the counterparties with the flexibility needed in structuring a complex OTC swap deal.[91]

Publication of the Guide indicates that firms have a strong preference for arbitration in resolving disputes in the derivatives market.[92] Indeed, this is consistent with the desire of firms dealing on the exchange-traded side to implement arbitration clauses as well.[93] The Guide's model arbitration clauses "reflect the comments of members and interested stakeholders" and represent an increasing use of arbitration in disputes over OTC derivative transactions.[94] This expansion is largely due to the "ease of enforcing an arbitral award" as opposed to a court judgment in an international setting.[95]

Although the model clauses in the Guide are tailored to the needs of specific members, each clause contains a standard provision requiring arbitration in the event of a dispute. Specifically, each clause contains the following language:

> Any dispute, claim, difference or controversy arising out of, relating to or having any connection with this Agreement, including any dispute as to its existence, validity, interpretation, performance, breach or termination or the consequences of its nullity and any dispute relating to any non-contractual obligations arising out of or in connection with it (a "Dispute"), shall be referred to and finally resolved by arbitration.[96]

Id. Three types of ISDA membership exist. A "primary member" is an "investment, merchant or commercial bank or other corporation, partnership or other business organization that deals in derivatives as part of its business." *Member Types*, Int'l Swaps & Derivatives Ass'n, http://www2.isda.org/membership/member-types (last visited Apr. 25, 2015). An "associate membership" is "[d]esigned for service providers . . . who are active in the privately negotiated derivatives business." *Id.* A "subscriber membership" is "[f]or corporations, financial institutions and government entities and others who use privately negotiated derivatives to better manager financial risks." *Id.*

88. *See About ISDA*, *supra* note 86.

89. David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 Colum. L. Rev. 152, 185 n.142 (2012).

90. *See* 2013 ISDA Arbitration Guide, *supra* note 22.

91. *ISDA Drafts Model Arbitration Clauses for Use with Master Agreements*, Allen & Overy (2013) [hereinafter Allen & Overy], *available at* http://www.allenovery.com/publications/en-gb/Pages/ISDA-drafts-model-arbitration-clauses-for-use-with-master-agreements.aspx.

92. *See* 2013 ISDA Arbitration Guide, *supra* note 22, at 4.

93. *Id.*

94. *Id.* at i.

95. Allen & Overy, *supra* note 91.

96. 2013 ISDA Arbitration Guide, *supra* note 22, at apps. A–G.

The member feedback that these provisions were drafted in response to "showed little appetite" for more complex alternatives, such as optional arbitration clauses where a party could choose to litigate or arbitrate a dispute arising out of a derivative transaction.[97] Because these model clauses merely serve as guides, concerned parties may freely tailor a provision to meet a specific transaction's needs. Accordingly, counterparties not constrained to the views expressed by the SEC and CFTC have more leeway and bargaining freedom to structure their agreements as they please.

III. PROBLEM: PUTTING SQUARE PEGS IN ROUND HOLES

From the discussion above, we can make two important observations. First, investors' needs change depending on whether they are an institution or a private party. Institutional investors arguably have more equal bargaining power with firms they are transacting with than smaller private investors do.[98] This obviates the need for blanket provisions prohibiting mandatory pre-dispute arbitration clauses, since this is a point of negotiation for which they can effectively bargain. The CFTC's carve out allowing institutional investors to waive their right to bring private claims is likely an example of this, since institutional investors are better positioned to make an informed decision about whether to waive their right to litigation.[99] In this vein, perhaps the SEC's reluctance to issue rules in a timely fashion is also a nod to the complexities associated with the wide range of customers investing in securities-based products.[100]

Second, parties' attitudes toward arbitration change depending on the type of derivative in question. On the one hand, the investing public disdains mandatory arbitration when dealing in securities or securities-based derivatives.[101] On the other hand, when examining ISDA members' feedback, it seems that investors of OTC swaps dealing internationally prefer arbitration to litigation since different risks are associated with these transactions.[102] Hampering the ability to exercise this preference could put a chilling effect on the OTC derivatives market, which contradicts Dodd-Frank's policy of creating a functional regulatory scheme.[103]

Together, these two observations raise the question: For those corners of the derivatives market in which mandatory pre-dispute arbitration clauses are left unregulated, what should be done to properly address the competing forces at play? More importantly, how should the Commissions use their rulemaking authority to

97. Allen & Overy, *supra* note 91.

98. *See* BATNA discussion *infra* Part III.B.

99. *See generally* Winship, *supra* note 73.

100. *See generally* Lynch, *supra* note 20.

101. *See* discussion *supra* Part I.

102. *See* discussion *supra* Part I. Specifically, international financial transactions are subject to a heightened level of enforcement risk not seen in local transactions. For a full discussion on ways to mitigate this enforcement risk, see 2013 ISDA Arbitration Guide, *supra* note 22, § 2.

103. *See* Lamson & Allen, *supra* note 30, at 498.

address this issue in the context of mixed OTC swaps? The bargaining power individual investors possess in transacting with large firms is certainly disconcerting. At the same time, however, blanket provisions will stymie competition and negotiation within the markets, which could just as easily lead to similarly adverse results. Where, then, do those tasked with regulating mandatory pre-dispute arbitration clauses in OTC swap transactions draw their lines? A better understanding of the types of swaps available to investors will shed light on potential answers to these questions.

A. Defining the Issue: What Is a Swap?

The SEC and CFTC have issued joint final rules that, among other things, add clarity to the definition of "swap" under the CEA and "security-based swap" under the Exchange Act.[104] Section 721 of Dodd-Frank amended the CEA and the Exchange Act to provide two definitions distinguishing the terms swap, security-based swap, mixed swap, and non-security-based swaps.[105] As amended, the CEA broadly defines a "swap" as:

> [A]ny agreement . . . that provides on an executory basis for the exchange . . . of 1 or more payments based on the value or level of 1 or more . . . rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind . . . and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred.[106]

This definition is subject to various exclusions.[107] The Commissions make clear that classifying a financial product as a swap or security-based swap (which the Commissions refer to as "Title VII instruments") is determined based on the underlying index or rate on which that product is based.[108] Title VII instruments based on interest or other monetary rates are considered swaps, whereas those based on the yield of value of a security, loan, or narrow-based security index are considered security-based swaps.[109]

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104. *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed-Swaps; Security-Based Swap Agreement Recordkeeping, 17 Fed. Reg. 48,207 (Aug. 13, 2012) (codified at 17 C.F.R. § 230, 240, and 241 (2014)).

105. Dodd-Frank, Pub. L. No. 111-203, § 721, 124 Stat. 1376 (2010) (codified as amended at 7 U.S.C. § 2(a)(1) (2013)).

106. 7 U.S.C. § 1a(47)(A)(iii).

107. These exclusions include, among other things, forward contracts, foreign exchange forwards, and foreign exchange swaps. *See generally id.* § 1a.

108. *Id.*

109. *Id.* The CEA and Exchange Act generally define a "narrow-based security index" as an index with nine or fewer component securities. Other instances exist, however, in which an index may qualify as a narrow-based security index. *See id.* § 1a(35).

The Commissions define a "mixed swap" as a contract that is a security-based swap and based on either: (1) an underlying reference other than a single security or narrow-based security index, such as an interest rate or other monetary rate, currency, commodity, etc.; or (2) the occurrence of an event associated with a potential financial, economic, or commercial consequence other than an event relating to an issuer of a security or the issuers in a narrow-based security index.[110]

Although these definitions appear to be relatively straightforward, "[c]haracterizing a particular instrument as a swap, security-based swap, mixed swap or an instrument that is exempt from swap regulation is a complicated matter and is the subject of a 585-page joint release" issued by the Commissions.[111] Despite the apparent difficulty in drawing distinct lines between the various types of OTC transactions, these definitions allow us to distill two additional takeaways. First, we know which agency has jurisdiction over each category of OTC swap transaction. As mentioned above, the SEC has jurisdiction over security-based swaps and the CFTC has jurisdiction over all transactions that are not security-based swaps, but are instead simply categorized as swaps.[112] The Commissions share jurisdiction over mixed swaps, but have yet to exercise this shared authority.[113]

Second, we know each respective agency's current attitude toward the use of mandatory pre-dispute arbitration clauses. The SEC possesses the authority to ban the use of mandatory pre-dispute arbitration clauses under Dodd-Frank in all derivative transactions within the purview of its jurisdiction, but has not yet done so. The CFTC and NFA, however, take the position that a valid, non-coerced pre-dispute mandatory arbitration clause is binding if signed by the investor. Signing a pre-dispute arbitration clause, however, cannot be mandatory.

If the SEC chooses to exercise its power under Dodd-Frank and enact a blanket prohibition on the use of these clauses, it will create an inconsistency with the CFTC approach.[114] This will not only produce uncertainty for firms dealing in OTC swaps, but will also erect haphazard boundaries between the various categories of swaps that do not accurately reflect the practicalities and economic substance of each contract. It is to these problems that this note now turns.

B. The Power Distribution in an OTC Swap Transaction

The jurisdictional divide between the SEC and CFTC does not reflect the categorical differences between OTC swaps and exchange-traded derivatives. "OTC

110. *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed-Swaps; Security-Based Swap Agreement Recordkeeping, 17 Fed. Reg. 48,210 (Aug. 13, 2012) (codified at 17 C.F.R. § 230, 240, and 241 (2014)).

111. Davis Polk, An Asset Manager's Guide to Swap Trading in the New Regulatory World 3 (2013), *available at* http://www.davispolk.com/files/uploads/An_Asset_Managers_Guide_to_Swap_Trading.pdf.

112. *See* discussion *supra* Part II.A.

113. *See* discussion *supra* Part II.A.

114. *See* discussion *supra* Part II.A.

swaps" are defined as "customized, bilateral agreements that transfer risk from one party to another."[115] An OTC deal takes place between two private parties.[116] Instead of utilizing a centralized trading mechanism, "buyers and sellers negotiate terms privately, often in ignorance of the prices currently available from other potential counterparties and with limited knowledge of trades recently negotiated elsewhere in the market."[117] Generally, broker-dealers forward orders to their own derivatives desks and to other derivatives dealers if required, after which the two parties trade based on a customized agreement.[118]

In contrast, "exchange-traded derivatives" are categorically defined as listed derivatives that "are executed over a centralized trading venue . . . and then booked with a central counterparty known as a clearing house."[119] Orders are originated and collected by broker-dealers from their customers and then forwarded to exchanges for execution.[120] The "[t]rading parties usually remain anonymous"[121] and the face-to-face negotiating element of the transaction is therefore eliminated.

These two categories present divergent challenges and opportunities for a transaction's counterparties. The extent of this disparity is reflected in each counterparty's bargaining position which, in turn, impacts each party's ability to effectively negotiate favorable terms. Accordingly, the need for regulation governing mandatory pre-dispute arbitration clauses in a respective derivative transaction will differ depending on which economic category the transaction falls into.

For example, the terms of an exchange-traded contract, "including delivery places and dates, volume, technical specifications, and trading and credit procedures," are completely standardized for each type of financial product being sold.[122] For OTC swaps, all of these terms are negotiable.[123] If the standardized exchange-traded contract contains a mandatory pre-dispute arbitration clause, the investor is limited to one of two rigid choices: (1) sign the contract or (2) walk away. Conversely, assuming all else remains equal, an investor negotiating an OTC swap transaction has greater power to argue for favorable terms. If a party does not agree to the inclusion of a mandatory pre-dispute arbitration clause, he has room to bargain for different terms before deciding to walk away.

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115. *See* ISDA FAQ, *supra* note 20.

116. *See* Darrell Duffie, Dark Markets: Asset Pricing and Information Transmission in Over-the-Counter Markets 1 (2012).

117. *Id. But see* discussion *infra* Part IV.A.

118. *See* Deutsche Börse Group, The Global Derivatives Market: An Introduction 17 (2008) [hereinafter Derivatives Market Intro], *available at* http://www.math.nyu.edu/faculty/avellane/global_derivatives_market.pdf.

119. *See* ISDA FAQ, *supra* note 20.

120. R. Madhumathi, Derivatives and Risk Management 48 (2012).

121. *Id.*

122. *See* ISDA FAQ, *supra* note 20.

123. *See* Duffie, *supra* note 116.

Bargaining flexibility also depends on the power dynamic at play in a given transaction.[124] "Given the situational nature of power, one should not be surprised to find that it flows from an almost infinite set of sources."[125] In their article entitled *When David Meets Goliath: Dealing with Power Differentials in Negotiations*, Professors Robert S. Adler and Elliot M. Silverstein showcase various overlapping sources of power at play in a given transaction.[126] Of these power sources, the existence of "organizational power" is most important in the context of an OTC swap transaction given the market's polarized distribution of investor "sizes." "Organizations produce and enhance power for fairly obvious reasons. They provide financial and human resources that vastly exceed those that can be mustered by isolated individuals."[127] In an OTC transaction, then, the distribution of organizational power will depend on the type and size of a given investor. One useful way to analyze this interplay is to examine the breakdown of OTC swap customers by their underlying asset class which, as discussed above, bears on the categorical definition provided by the Commissions.[128] A recent study published by the Deutsche Börse Group[129] presents such a classification, and can be summarized as follows:

		Underlying Asset Class					
		Fixed-income	Foreign Exchange	Credit	Equity	Commodities	Fund-linked
Customer Type	Public Sector/ Other	6%	12%	6%	3%	6%	1%
	High Net Worth Individuals	10%	13%	4%	33%	4%	59%
	Corporates	31%	36%	6%	12%	70%	3%
	Financial Institutions	53%	39%	84%	52%	20%	37%

Although the exact classification will fluctuate depending on the revenue reported by each OTC derivatives dealer in a given year, these statistics show that the proportionate distribution of investor categories in the OTC market largely depends on

124. Robert S. Adler & Elliot M. Silverstein, *When David Meets Goliath: Dealing with Power Differentials in Negotiations*, 5 Harv. Negot. L. Rev. 1, 22 (2000).

125. *Id.*

126. *Id.* at 23. These categories in include: (1) personal power; (2) organizational power; (3) informational power; and (4) moral power. *Id.*

127. *Id.* at 24–25.

128. *See* discussion *supra* Part II.A.

129. "Deutsche Börse Group is one of the largest exchange organisations worldwide. It organises markets characterised by integrity, transparency and safety for investors . . . ." *Deutsche Börse Group—Company Profile*, Deutsche Börse Group, http://deutsche-boerse.com/dbg/dispatch/en/kir/dbg_nav/about_us/10_Deutsche_Boerse_Group (last visited Apr. 25, 2013). These research findings were published in a white paper entitled "The Global Derivatives Market: An Introduction." *See generally* Derivatives Market Intro, *supra* note 118.

the underlying asset class of the financial product in question. For example, we know that in the representative year above, the majority of corporate customers invested in commodities-based OTC swaps. We also know that commodity-based swaps fall within the CFTC's jurisdiction and that the NFA generally considers coerced mandatory pre-dispute arbitration clauses unenforceable when used in exchange-traded transactions. On the one hand, the CFTC and NFA's position that mandatory pre-dispute arbitration clauses are generally unenforceable would lead to unnecessary overregulation for the majority of customers—the corporate customers—in this sample.[130] Corporate customers, when compared to individual investors, possess more organizational power when negotiating with an OTC dealer in this context. Accordingly, regulating them would be much less needed. Indeed, to the extent that an arbitration provision could ever be characterized as "mandatory" in this situation, the customer would arguably be in a better position to advocate for more favorable terms in other aspects of the agreement. On the other hand, if the CFTC and NFA were to leave mandatory pre-dispute arbitration clauses completely unregulated for commodity-based OTC swaps, then the four percent of individual investors who possess less organizational power—and are therefore more prone to harm—would be left vulnerable and unprotected. This same logic could be applied to those OTC transactions falling within the purview of the SEC's jurisdiction, such as transactions between dealers and the various customers for equity-based OTC swaps.

Of course, the ability to negotiate the terms of a transaction does not stem solely from the availability of flexible provisions or the distribution of organizational power in a respective agreement. Negotiating power can also be derived from the interdependence between the counterparties and the availability of alternatives to the transaction at issue.[131] Interdependency and the availability of alternatives therefore play different roles in an exchange-traded transaction and an OTC swap transaction.

"In most relationships, power flows from the more dependent to the less dependent party."[132] Although calculating specific levels of dependency is troublesome without knowing the specifics of a given OTC swap negotiation, dependency is certainly a function of the availability of alternatives. The concept commonly referred to as "Best Alternative to a Negotiated Agreement" (BATNA) suggests that "[i]f one has a number of attractive alternatives to a deal with one's opponent, one has great power regardless of the tremendous resources that the other side might have within its control."[133] Thus, if a party has more alternatives to choose from, that party is less

130. If a corporate customer fell within the "institutional investor" carve out, then the customer may be able to waive its right to bring private litigation. *See supra* Part II.C.2.

131. Adler & Silverstein, *supra* note 124, at 19–20.

132. *Id.* at 19.

133. *Id.* at 20. "Negotiation theory assumes that settlements and agreements are consensual. Each party to a negotiation is free to walk away from the bargaining table without a deal. Each party is assumed to have alternatives that can be pursued without the agreement of the other negotiator." Alex J. Hurder, *The Lawyer's Dilemma: To Be or Not to Be a Problem-Solving Negotiator*, 14 Clinical L. Rev. 253, 268 (2007). Some legal scholars suggest that possessing greater power does not guarantee a successful bargaining outcome. "Disproportionately greater power on the part of one party in a negotiation often reduces the

dependent on its counterparty. If fewer alternatives are available, that party is more dependent on its counterparty. Of course, a party's negotiating power will further depend on the quality of these alternatives as they relate to that party's goals and interests.[134] Accordingly, a wholesale ban on pre-dispute arbitration clauses would lead to significant over-regulation, since those larger investors with more alternatives and less dependency would no longer have the ability to informatively waive their right to litigation.

As we know, "[t]he derivatives market is highly competitive."[135] A tenet of modern economics is that in a competitive market, consumers have a large number of options.[136] In the financial markets, a glut of available products stemming from this competition provides market participants with options between three general categories of alternatives: "(a) choice between OTC dealers within the OTC segment, (b) choice between the OTC and on-exchange segments for many contract types, and (c) choice between different derivatives exchanges."[137] Within the first category, investors have a host of different OTC swap dealers to pick from. In fact, the list of provisionally registered swap dealers is continually expanding.[138] Within the third category, investors can choose between roughly twenty-five major exchanges.[139] While the availability of these exchanges hinges on the type of financial product in question, investors are by no means limited solely to one opportunity to invest their money. Instead, investors have a plethora of options that, according to BATNA, further decrease any dependency that may have existed, therefore increasing their negotiating power—independent of each investor's organizational power.

But that is just the tip of the iceberg; the availability of alternatives can be multiplied further. Because some OTC swaps and exchange-traded alternatives achieve the same economic purpose, alternatives available to derivative traders percolate.[140] Coupling the categorical choices available to an investor with the

likelihood of a favorable outcome for the powerful party, producing what Professor William Ury calls the 'power paradox': 'the harder you make it for them to say no, the harder you make it for them to say yes.'" Adler & Silverstein, *supra* note 124, at 16–17.

134. Investors purchase derivatives for a variety of reasons. For ease of analysis, this note assumes that derivatives are purchased to maximize return.

135. Derivatives Market Intro, *supra* note 118, at 19.

136. Eric A. Nilsson, Capitalism: Power, Profits, and Human Flourishing 208 (2004).

137. Derivatives Market Intro, *supra* note 118, at 21.

138. *Dodd-Frank Act: Provisionally Registered Swap Dealers*, U.S. Commodity Futures Trading Comm'n, http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer (last visited Apr. 25, 2013).

139. *See All Futures Markets*, Barchart, http://www.barchart.com/futures/all_futures.php (last visited Apr. 25, 2015) (listing all commodities sorted by exchange).

140. *See* Derivatives Market Intro, *supra* note 118, at 21. The following examples illustrate this point:

> [B]oth an interest rate swap with a maturity of five years—a classic OTC product—and an exchange-traded future on a five-year government bond offer protection against interest rate changes over a time horizon of five years.
>
> Similarly, OTC derivatives dealers offer forward transactions on any equity index for all maturities that users could request. Derivatives exchanges offer futures (the

possibility of achieving the same economic outcome through different investment vehicles paints a seemingly endless canvas of choices. With the above logic, limitless choices virtually eliminate each party's dependency, and reduced dependency substantially increases both parties' bargaining power. The more bargaining power a party possesses, the more "fair" a transaction becomes, which mitigates the need for a negotiation to be regulated in the first place.

The arbitration problems associated with the split jurisdiction between the Commissions reach their apex when a firm trading in OTC swaps is registered with both Commissions' SROs: the NFA and FINRA.[141] The NFA requires all disputes involving commodity futures contracts between a customer and a registrant to be arbitrated with the NFA.[142] Similarly, an investor must arbitrate with FINRA if the dispute is with a FINRA member.[143] So then, where do disputes arising out of mixed OTC swap transactions (within the jurisdictional purview of both the SEC and CFTC) involving firms registered with both the NFA and FINRA get arbitrated?

Dodd-Frank requires the Commissions to jointly prescribe regulations regarding mixed swaps, but such action has yet to be taken.[144] Recently, the CFTC issued a release stating that under a proposed set of rules:

> [B]ilateral, uncleared mixed swaps, where one of the counterparties is dually registered as a dealer or major participant with both the CFTC and also with the SEC, would be subject to certain key provisions of the CEA and related CFTC rules as well as the requirements of the federal securities laws. For all other mixed swaps, the Commissions are proposing a process where a person who desires or intends to list, trade, or clear such a mixed swap (or class thereof) can ask the agencies for a joint order . . . .[145]

Under this proposed regime, a dually-registered firm initiating a "take it or leave it" approach to a pre-dispute arbitration provision in a bilateral, uncleared OTC swap arrangement would still likely be bound by NFA arbitration rules since the scope of those rules are determined by the definitions used in the CEA—such as

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> on-exchange equivalent of a forward transaction) on many equity indices as well—although, only for a fixed set of maturity dates. Both products can be used for the same purpose of obtaining exposure to the same underlying equity index.

Id.

141. Recall that firms trading in financial products within a Commission's jurisdiction are required to register as a member of that Commission's SRO. *See* discussion *supra* Part I.

142. "(a) Mandatory Arbitration. . . . [T]he following disputes shall be arbitrated under this Code if the dispute involves commodity futures contracts: (i) a dispute for which arbitration is sought by a customer against a Member or employee thereof, or Associate, provided that: (A) the customer is not an FCM, floor broker, Member or Associate . . . ." Code of Arbitration, *supra* note 16, § 2.

143. *Arbitration Overview*, Fin. Indus. Regulatory Auth., https://www.finra.org/ArbitrationAndMediation/Arbitration/Overview/ (last visited Apr. 25, 2015).

144. Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed-Swaps; Security-Based Swap Agreement Recordkeeping, 17 Fed. Reg. 48,207, at 48,209 (Aug. 13, 2012) (codified at 17 C.F.R. § 230, 240, and 241 (2014)).

145. CFTC Q&A, *supra* note 35.

"associate" or "Futures Commission Merchant."[146] For all other swaps, the Commissions must work together in issuing a joint order resolving the jurisdictional boundaries in play. Due to the divergent approaches taken by the Commissions regarding the enforceability of mandatory pre-dispute arbitration clauses, it is unclear what compromise will emerge from the flames.

IV. SOLUTION: LATHING THE PEGS

So far, this note has shown that the Commissions are currently bifurcated in their approaches to regulating pre-dispute arbitration clauses in OTC swap transactions. If the SEC chooses to exercise its rulemaking authority granted under Dodd-Frank, it may limit or ban these clauses altogether. Anything other than a mirror image of the CFTC approach will create an inconsistency. But such a tactic, as this note has also demonstrated, does not accurately account for the actual needs of the various customers investing in OTC swaps and does not reflect the economic substance of these transactions. Rather than delineating clear, pragmatic, and workable boundaries, the current regulatory scheme is plagued with arbitrary distinctions that pigeonhole the Commissions into a no-win situation.[147]

In light of these shortcomings, this note proposes that the Commissions, with assistance from the ISDA, implement a two-phase approach to regulating pre-dispute arbitration clauses in OTC swap transactions. Phase One would involve, through notice and comment rulemaking, a very limited approach by the Commissions to issue regulations addressing the deficiencies discussed above. Phase Two, in turn, would require the ISDA, as part of its Dodd-Frank Documentation Initiative,[148] to issue an updated Protocol encouraging market participants to adhere to the Commissions' new rules by supplementing the terms of existing swap agreements in which counterparties have used the model arbitration clauses published in the 2013 ISDA Arbitration Guide. Additionally, this phase would require the ISDA to publish new model clauses to be used in conjunction with transactions falling within the Commissions' jurisdiction. The following two sections outline these proposed phases.

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146. *See generally* 7 U.S.C. § 1a (2013).

147. Other concerns, such as regulatory arbitrage—stemming from gaps in agency rules or inconsistencies between agency approaches to regulation—exist but are beyond the purview of this note. Indeed, the Commissions are aware of these risks and have acknowledged the need to reduce the potential for regulatory arbitrage by publishing a notice asking if their two approaches are comparable or different, and whether any difference is likely to impact market participants. *See, e.g.*, End-User Exception to Mandatory Clearing of Security-Based Swaps, Exchange Act Release No. 34-63556 (Dec. 15, 2010).

148. "ISDA's Dodd-Frank Documentation Initiative [is] aimed at assisting the industry in implementing and complying with the regulatory requirements imposed under Title VII of [Dodd-Frank]. In order to facilitate implementation of Dodd-Frank rulemakings, ISDA plans to launch future Protocols to simplify documentation changes for upcoming CFTC and SEC final rules . . . ." *ISDA March 2013 DF Protocol*, Int'l Swaps & Derivatives Ass'n (2013), *available at* http://www2.isda.org/functional-areas/protocol-management/protocol/12.

A. Phase One: Limited Regulation of Non-cleared OTC Swaps

Customers investing in OTC swaps range from individuals and small public entities to large corporations and other financial institutions.[149] As such, the negotiating leverage at play in each of these transactions will depend on the various factors discussed above. Those transactions most vulnerable to the risks associated with the "take it or leave it" approach to pre-dispute arbitration involve a relatively powerless investor privately negotiating with a large financial institution.[150] But lawmakers recently passed legislation that substantially diminishes this exposed vulnerability in face-to-face OTC swap transactions. Beginning in 2012, the Commissions began requiring many types of "swaps [that] have traditionally been entered into over the counter . . . to be cleared through clearinghouses and traded on exchanges."[151] These clearinghouses serve as transactional gatekeepers, thereby protecting customers from many of the negotiation risks associated with non-cleared OTC swaps.[152]

As noted above, non-cleared OTC swap transactions are bilateral and are typically executed in person or over the phone between the buyer and seller.[153] By requiring counterparties to an OTC swap transaction to clear through a central counterparty, each participant knows exactly who maintains which positions.[154] This eliminates the need to protect an investor against any imbalance—perceived or otherwise—in the power distribution when negotiating with a large financial institution. Moreover, by requiring a central counterparty, a market participant no longer has "to face a counterparty that ha[s] the necessary balance sheet and credit to be able to stand behind a trade."[155] Nathan Jenner, the chief operating officer of

149. *See* Derivatives Market Intro, *supra* note 118, at 9.

150. *See* BATNA discussion *supra* Part III.B.

151. *Swap*, Practical L., http://us.practicallaw.com/0-382-3858?q=Swap+definition (last visited Apr. 25, 2015) (emphasis omitted). The phase-in schedule was proposed as follows:

Category 1	Swap Dealers, Major Swap Participants, and Active Funds	March 11, 2013
Category 2	Commodity Pools, Hedge Funds, and Non-Swap Dealer Banks	June 10, 2013
Category 3	All Other Entities Required to Clear	September 9, 2013

CFTC Announces That Mandatory Clearing Begins Today, U.S. Commodity Futures Trading Comm'n (Mar. 11, 2013), http://www.cftc.gov/PressRoom/PressReleases/pr6529-13; *CFTC Announces That Mandatory Clearing for Category 2 Entities Begins Today*, U.S. Commodity Futures Trading Comm'n (June 10, 2013), http://www.cftc.gov/PressRoom/PressReleases/pr6607-13; *CFTC Announces That the Third Phase of Mandatory Clearing of Certain Credit Default Swaps and Interest Rate Swaps Begins Today*, U.S. Commodity Futures Trading Comm'n, http://www.cftc.gov/PressRoom/PressReleases/pr6684-13 (last updated Sept. 9, 2013).

152. *See generally Summary of the Dodd-Frank Act: Swaps and Derivatives*, Practical L. (2013), http://us.practicallaw.com/resource/3-502-8950.

153. *See* BATNA discussion *supra* Part III.B.

154. *See Evolution of the OTC Swaps Market*, Bloomberg (2013), *available at* http://www.bloomberg.com/professional/content/uploads/sites/2/2013/07/54104667-fi-us-garp-wnar-idoc.pdf.

155. *Id.*

Fixed Income E-Trading at Bloomberg, posits that this type of situation essentially leads to the equalization of credit:

> The credit facing a big bank like Goldman Sachs, JP Morgan or Bank of America arguably will no longer be different than the credit facing a much smaller bank, or potentially even a hedge fund, and that's because all parties of the transaction will be giving up their trade to face a central clearing venue.[156]

It stands to reason that by equalizing credit between a small bank and a large institution, as Jenner suggests, the small bank retains more organizational power compared to the big bank. With more organizational power, less protection is needed. Accordingly, it makes sense that the new clearing requirements obviate the need to limit or ban the use of mandatory pre-dispute arbitration clauses in those swap agreements subject to mandatory clearing. By mitigating the concerns that gave rise to the uproar against these clauses in the first place, the new mandatory clearing rules render other regulatory initiatives—such as the proposed Investor Choice Act of 2013—superfluous.

For those OTC swaps that are excluded from the clearing requirements,[157] the Commissions should tread lightly in enacting legislation and should limit their rulemaking to non-cleared OTC swaps. Any proposed rule should adopt a more prescriptive-based approach taking into consideration the actual bargaining power at play in the transaction. The Commissions must acknowledge the size of each counterparty, the availability of options, and take extreme caution to not draw arbitrary lines based on the classification of the underlying asset for the derivative in question. By taking a balanced approach to limiting mandatory pre-dispute arbitration clauses, the Commissions will promote the conflicting policy goals that Congress has struggled with since before it enacted Dodd-Frank: promoting uniformity in rulemaking and maintaining a functional regulatory split between the

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156. *Id.* (internal quotation marks omitted).

157. Fixed-to-floating swaps, basis swaps, forward rate agreements, and overnight index swaps are excluded from clearing if they include optionality, dual currencies, or conditional notional amounts. The term "conditional notional amount" is defined as notional amounts that can change over the life of a swap "based on a condition established by the parties upon execution such that the notional amount of the swap is not a known number or schedule of numbers, but may change based on the occurrence of some future event." Susan Milligan, OTC Interest Rate Swaps: Mandatory Clearing Summarized 5 (Dec. 7, 2012), *available at* http://www.swapclear.com/Images/lch_cftcdetermbriefing_09_tcm14-62734.pdf. Swaptions and extendable swaps are also excluded:

> The clearing requirement does not apply to swaps created after the commencement of mandatory clearing by the exercise or expiry of swaptions entered prior to the commencement of mandatory clearing. The [CFTC] states that the clearing requirement only applies to swaps resulting from the exercise of a swaption or extendible swap extension if the clearing requirement would have been applicable to the underlying swap or the extended swap at the time the counterparties executed the swaption or extendible swap.

Id. As of June 30, 2013, the value of non-cleared derivatives within the derivative market was said to be $79 trillion. *See* Int'l Swaps & Derivatives Ass'n, The Value of Derivatives (2014), *available at* https://www2.isda.org/attachment/NjQ3Mw==/ISDA%20FINAL%202014.pdf.

SEC and CFTC.[158] This will, in turn, mitigate the chance of over-regulation and lessen the possibility of chilling an otherwise competitive market.

Moreover, once the Commissions have sufficiently untangled the jurisdictional knot surrounding mixed swaps, they must clearly delineate which types of OTC swaps are subject to FINRA's arbitration rules and which are subject to the NFA arbitration rules. In situations where the counterparty is a member of both FINRA and the NFA, and depending on the precise language of the arbitration provision in play, a counterparty to a mixed swap transaction may have the choice between FINRA and NFA arbitration.[159] The differences between these two arbitration forums,[160] and the apparent regulatory gap in this context, gives rise to the danger of regulatory arbitrage.[161] By enacting clearly defined rules, the Commissions will further another congressional goal by drafting Dodd-Frank's joint rulemaking provisions—preventing such arbitrage opportunities.[162]

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158. Lamson & Allen, *supra* note 30, at 499.

159. In response to any potential deficiencies, many interested constituents have already begun to consider ways to improve the current SRO arbitration system. These improvements, when implemented, will effectively diminish the concerns fueling the move toward an outright ban on mandatory pre-dispute arbitration clauses. For a full discussion on the pros and cons of SRO arbitration, see William B.L. Little, *Fairness Is in the Eyes of the Beholder*, 60 Baylor L. Rev. 73 (2008) ("Arbitration can be a fair, efficient forum for the resolution of commercial disputes. Unfortunately, there exists a significant perception that SRO [] arbitration as currently structured is not impartial or economical.").

160. The differences between these two forums, and the rules governing each, are beyond the scope of this note. However, in his book *Investor's Guide to Loss Recovery: Rights, Mediation, Arbitration, and Other Strategies*, securities fraud expert Louis L. Straney elaborates on one key difference:

> There's a big difference between securities and commodities or futures cases. There is a two-year statute of limitations beginning when you knew, or should have known; where either you get to know, or you should have known; when the course of action arises. So, to simplify, you have to file your case within two years of knowing when you had a case. Some Futures Commission Merchants (FCMs) shorten that statute of limitations to one year. That is upheld by arbitration before the National Futures Association (NFA), but not by the reparations administration law judges. If you contrast that to securities, where you sign a customer agreement and are designated to resolve a dispute before FINRA, there's a six-year eligibility rule that applies. So, you really have six years to bring your case before FINRA. . . . The two different industries are quite distinct.

See Louis L. Straney, Investor's Guide to Loss Recovery: Rights, Mediation, Arbitration, and Other Strategies (2011) (footnotes omitted).

161. "Congress appears to have recognized that different products and markets can serve as economic substitutes and that if the agencies adopt rules that leave gaps or are inconsistent, there is a danger of regulatory arbitrage by exploitation of these gaps and inconsistencies." Lamson & Allen, *supra* note 30, at 499.

162. Mr. Lamson and Ms. Allen pose an interesting question in response to Congress requiring the Commissions to engage in joint rulemaking:

> "On the other hand, by not requiring uniform rulemaking, Congress seems to have empowered the agencies to permit such arbitrage opportunities. Does joint rulemaking in its present form prevent arbitrage and encourage the SEC and CFTC to implement a policy of increased regulation in a previously unregulated area or is it a subterfuge to allow the markets to pick their own regulator or avoid regulation altogether?"

Id.

B. Phase Two: ISDA Protocol

Although many OTC markets have already seen a movement toward standardization, "a large swath of the market is still going to need to customize and tailor their OTC derivative instruments."[163] The ISDA has already taken steps toward achieving standardization by publishing a suite of documents for use in OTC swap transactions.[164] The foundational documents published by the ISDA include the 1992 and 2002 ISDA Master Agreements, which establish "the global market standard" and "the contractual framework" for an OTC swap transaction.[165] These agreements comprise "a standard printed form, which sets out the principal clauses in detail[]" such that parties may tailor their bargain based on specific requirements.[166] Additionally, the ISDA published the Guide in 2013, providing general guidance on arbitration to ISDA members and a range of model arbitration clauses to be used in conjunction with the 1992 and 2002 Master Agreements.[167] Similarly, from time to time, the ISDA issues protocols to address contractual and legal issues that arise, providing "an efficient way of implementing industry standard contractual changes over a broad number of counterparties."[168] This is in connection with the Dodd-Frank Documentation Initiative, which seeks to simplify documentation changes for finalized SEC and CFTC rules.[169] The last protocol closed on September 17, 2014,[170]

163. *Evolution of the OTC Swaps Market*, *supra* note 154.

164. The scope of the ISDA's activities are summarized as follows:

> Starting in the late 1980s, the scope of [the] ISDA's activities began to expand beyond just documentation. [The] ISDA became involved in discussions with regulators on behalf of the OTC derivatives industry. [The] ISDA board members and representatives now regularly testify before congressional committees. [The] ISDA has played a key role in keeping the OTC derivatives industry self-regulated. It has coordinated industry opposition to CFTC and SEC regulation, acting both as an advocate for the industry and as an instrument for its self-regulation. [The] ISDA has also lobbied successfully to get legislation passed in the U.S. explicitly recognizing the validity of netting agreements for derivatives contracts in bankruptcy contexts.

Sean M. Flanagan, *The Rise of a Trade Association: Group Interactions Within the International Swaps and Derivatives Association*, 6 Harv. Negot. L. Rev. 211, 246–47 (2001) (footnotes omitted).

165. *See* Allen & Overy, ISDA Publishes Model Arbitration Clauses for Master Agreements (2013), *available at* http://www2.isda.org/attachment/NTg0Mg==/ISDA%20publishes%20model%20arbitration%20clauses%20for%20Master%20Agreements.pdf.

166. *Id.*

167. *Id.* "Although the governing law of the Master Agreement remains either English law or New York law, the model clauses provide a much greater variety of arbitral forums than the traditional choice between English and New York courts." *Id.*

168. *About ISDA Protocols*, Int'l Swaps & Derivatives Ass'n, http://www2.isda.org/functional-areas/protocol-management/about-isda-protocols/ (last visited Apr. 25, 2015).

169. *See* Int'l Swaps & Derivatives Ass'n, ISDA Dodd-Frank Documentation Initiative and August 2012 Dodd-Frank Protocol FAQ 1 (Aug. 13, 2012), *available at* http://www2.isda.org/attachment/NDcxMA==/DFDI%20and%20Protocol%20FAQ%200813%202012.pdf.

170. *Open Protocols*, Int'l Swaps & Derivatives Ass'n, http://www2.isda.org/functional-areas/protocol-management/open-protocols/ (last visited Apr. 25, 2015).

and the ISDA "plans to launch future Protocols to simplify documentation changes for upcoming CFTC and SEC final rules" and facilitate industry compliance.[171]

Against this backdrop, the Commissions should coordinate with the ISDA to publish a Protocol in response to the newly issued rules proposed in Phase One. This Protocol would seek to ensure compliance with the rules, while providing susceptible investors with the necessary information needed to decide whether to waive their right to litigation for disputes arising from non-cleared OTC swap transactions. Then, either by amending the Guide or publishing a U.S.-specific guide, the ISDA should provide model arbitration clauses that comply with the Commissions' newly enacted rules. For example, a standardized model clause (mirroring language used in the Guide) for a transaction falling under the CFTC's jurisdiction could read as follows:

> *Arbitration*
> (i) Any dispute, claim, difference or controversy arising out of, relating to or having any connection with this Agreement, including any dispute as to its existence, validity, interpretation, performance, breach or termination or the consequences of its nullity and any dispute relating to any non-contractual obligations arising out of or in connection with it (a "Dispute"), shall be referred to and finally resolved by arbitration.
>
> (ii) The arbitration shall be conducted in accordance with the [National Futures Association Arbitration Rules] (the "Rules"). Capitalised terms used in this Section which are not otherwise defined in this Agreement have the meaning given to them in the Rules.[172]

Although seemingly straightforward, such a clause would limit the pitfalls discussed above, reducing noncompliance and mitigating uncertainty. Syndicating resources to publish model clauses like this one will allow the Commissions and the ISDA to shelter those investors who truly need protection, while maintaining the flexibility to negotiate non-cleared OTC swap transactions.[173] By standardizing model pre-dispute

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171. *ISDA August 2012 DF Protocol*, Int'l Swaps & Derivatives Ass'n, *available at* http://www2.isda.org/functional-areas/protocol-management/protocol/8 (last visited Apr. 25, 2015).

172. *See* 2013 ISDA Arbitration Guide, *supra* note 22.

173. Various governmental agencies have already begun to syndicate resources to achieve common goals in other contexts. For example, to prevent employers from shifting workforces off the books by misclassifying workers as independent contractors:

> States have taken the lead in initiating reform efforts to combat independent contractor misclassification and subcontracting abuses by making better use of agency resources to document the problem and coordinate on enforcement and tightening up the rules to ensure employers are held accountable for their employees. Almost half of the states now have a task force or commission to document the problem and better direct enforcement efforts . . . .

Sarah Leberstein & Anastasia Christman, *Occupy Our Occupations: Why "We Are the 99%" Resonates with Working People and What We Can Do to Fix the American Workplace*, 39 Fordham Urb. L.J. 1073, 1100 (2012). In the context of financial reform, other scholars have also suggested a more "international framework" to protecting U.S. investors. *See, e.g.*, Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 Harv. Int'l L.J. 31 (2007). Moreover, the SEC has already taken steps toward coordinating with international regulators in defining rules governing parties to cross-border security-based swap transactions. *See SEC Proposes Rules for Cross-Border Security-Based Swap* arbitration clauses, counterparties will be encouraged to comply with the new rules because they would be confident in the enforceability of the clauses, certain over which arbitral forum will preside, and clear about which rules will apply to that forum. Standardization will therefore facilitate the competitive nature of the OTC market and allow counterparties to negotiate free of any fear that their bargained-for agreements will not be enforced.

V. CONCLUSION

As it stands now, both approaches employed by the SEC and CFTC fail to adequately or accurately regulate the use of pre-dispute arbitration clauses in OTC swap transactions. By taking a hard look at the market activity and actual power distributions at play in the OTC derivatives market, and scrutinizing the impact of rules already issued under Dodd-Frank, the Commissions will be better positioned to more precisely fill the void that currently exists in the regulatory scheme. A syndicated approach will lessen the chance for superfluous, broadly sweeping regulation and will instead provide sharpened clarity that will assist those customers in need of protection to make informed investment decisions. Similarly, a harmonized approach to developing more accurately polished laws will allow the OTC derivatives market to flourish by facilitating even-keeled bargaining between market participants. With that in mind, this note should not be read as a definitive solution to the problem. Instead, it merely serves to expose the flaws in the current regulatory system and suggests one possible approach to fixing those flaws. It is up to the regulators to sit down and hash out a workable solution that has a practical and positive influence on the OTC swap market.

Activities, U.S. Sec. & Exch. Comm'n (May 1, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514072#.VME0qsass_s ("The proposal outlines a 'substituted compliance' framework in order to facilitate a well-functioning global security-based swap market.").