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Regulating the U.S. Treasury Market

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REGULATING THE U.S. TREASURY MARKET

JERRY W. MARKHAM*

The market for U.S. Treasury securities is critical to our monetary policy and government funding. It also serves as a benchmark for pricing other investments and has provided a haven for investors seeking safety and stability. However, concern has recently arisen that “primary dealers” in that market might have manipulated prices. In addition, an unusual market volatility event that occurred in October 2014, and the growth of high-frequency trading have raised further questions over the adequacy of regulation in that market. This article addresses those concerns. It first describes the U.S. Treasury market and identifies efforts by traders over the years to manipulate prices. It will describe the existing regulatory structure, which allocates jurisdiction to multiple regulators that have overlapping missions. The article then advocates the creation of a more streamlined and efficient regulatory system that would be administered by a single business conduct regulator tasked with monitoring and policing abuses in this critical market.

I.	INTRODUCTION.....	186
II.	DEVELOPMENT AND STRUCTURE OF THE TREASURY MARKET.	188
	A. Development of the U.S. Treasury Market	188
	B. Government Debt Instruments	191
	C. Treasury Auctions	192
	D. Secondary Market.....	196
III.	REGULATORY STRUCTURE.....	199
	A. Banking and SEC Regulatory Jurisdiction	199
	B. CFTC Jurisdiction	201
	C. U.S. Treasury market Volatility on October 15, 2014	205
IV.	CONSOLIDATING REGULATION	208
	A. Functional Regulation	208
	B. Functional Regulation Has Been Undermined.....	212
	C. “Twin Peaks” Regulation.....	220
	D. Prudential Regulation.....	227
V.	CONCLUSION	230

I. INTRODUCTION

“The U.S. Treasury market is the deepest and most liquid government securities market in the world.”¹ It plays a critical role in funding the government and acts as an important tool in implementing the Federal Reserve Board’s (Fed) monetary policies.² The U.S. Treasury market also serves as a benchmark for pricing other securities, it provides a safe haven for investors seeking stability and safety, and it acts as a source of liquidity for the short-term working capital needs of many large businesses.³

The Treasury market also provides speculative opportunities when interest rates fluctuate or market uncertainty accelerates.⁴ Accompanying this speculative trading have been several scandals involving traders who tried to manipulate Treasury security prices. As will be described below, the first of those scandals occurred with the inception of U.S. government bond issues in the 1790s.⁵ More recently, in 2015, several large financial institutions that act as “primary dealers”⁶ in the Treasury market became the targets of governmental investigations seeking to determine whether they manipulated that market.⁷

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1. U.S. DEP’T OF THE TREASURY ET AL., J. STAFF REP.: U.S. TREASURY MARKET ON OCTOBER 15, 2014, at 1 (July 2015) [hereinafter DEP’T OF THE TREAS. J. REP. 1].

2. *Id.*

3. As further described by one author:

There are about \$12.5 trillion in marketable securities outstanding, and primary dealers trade an average of around \$500 billion every day with their clients and with other parties. Treasury securities play a variety of roles in the U.S. economy. They are, of course, the federal government’s primary vehicle for financing the federal deficit and refinancing maturing debt. Global investors use Treasuries for investing and hedging purposes, and as benchmarks for pricing other types of assets. In addition, many in the public and private sectors use Treasury yields to glean information about expectations for the future course of the U.S. and global economy.

Simon Potter, *Challenges Posed by the Evolution of the Treasury Market* (Apr. 13, 2015), <http://www.newyorkfed.org/newsevents/speeches/2015/pot150413.html> [https://perma.cc/576W-T743] (footnote omitted).

4. *See id.*

5. JERRY W. MARKHAM, LAW ENFORCEMENT AND THE HISTORY OF FINANCIAL MARKET MANIPULATION 14 (2014) (describing some of those manipulations).

6. Primary dealers are designated as such by the Federal Reserve Bank of New York. That designation allows those dealers to participate broadly in Treasury auctions and to distribute Treasury securities to other market participants. Primary dealers include large banks and broker-dealers. Federal Reserve Bank of New York, *Primary Dealers*, <http://www.newyorkfed.org/markets/primarydealers.html> [https://perma.cc/DKU2-STLR] (last visited Nov. 21, 2016).

7. Alexandra Scaggs, Daniel Kruger & Keri Geiger, *Primary-Dealer Trader Talk is Open Secret*

Concerns over speculative abuses in the U.S. treasury market had been heightened earlier after unusual volatility occurred in that market on October 15, 2014.⁸ The growing presence of high-frequency traders (HFTs) and concerns over their trading practices are raising additional doubts over the adequacy of the multi-tiered regulatory structure that now exists for the Treasury market.⁹

This article will describe the development and operation of the U.S. Treasury market and will address historical concerns over speculation and manipulation of prices of those instruments. It will then describe the present structure of the U.S. Treasury market and the allocation of jurisdiction of its operations among a host of regulators, including the Department of the Treasury (Treasury), the Board of Governors of the Federal Reserve System (Fed), the Federal Reserve Bank of New York (New York Fed), the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). The article will describe prior manipulations of the Treasury market, the events that occurred in the U.S. Treasury market on October 15, 2014, and recent concerns with possible price manipulations. The article will then advocate a reformation of the current regulatory structure that would combine business conduct regulation into a single

as *U.S. Collusion Probe Turns to Treasuries*, SEC. REG. & L. REP. (BNA) 1286 (June 29, 2015). After the press reported those investigations, numerous private lawsuits were also filed against those primary dealers. Joe Rennison, *Investor Lawsuits Pile Up Claiming US treasury Market is Rigged*, FIN. TIMES (LONDON) (Sept. 28, 2015), <http://www.ft.com/cms/s/0/43f0b014-6218-11e5-9846-de406ccb37f2.html#axzz4HRfl46fj> [<https://perma.cc/7CUL-BHML>] (noting that twenty-five such lawsuits were filed or in the process of being filed). Several of these banks had earlier paid billions of dollars to settle charges that they had massively manipulated interest rate and foreign exchange benchmarks. See, e.g., *In re Deutsche Bank AG*, CFTC No. 15-20 (Apr. 23, 2015) (consent order for criminal and civil charges of manipulating the Euro Interbank Offered Rate (Euribor)); *In re The Royal Bank of Scotland plc*, CFTC No. 13-14 (Feb. 6, 2013) (yen and Swiss franc LIBOR); *In re Coöperatieve Centrale Raiffeisen-Boerenleenbank, B.A.*, CFTC No. 14-02 (Oct. 29, 2013) (LIBOR rates and Euro Interbank offered rates); *In re ICAP Europe Ltd.*, CFTC No. 13-38 (Sep. 25, 2013) (manipulation of Yen LIBOR); *In re HSBC Bank plc*, CFTC No. 15-07 (Nov. 11, 2014) (benchmark currency rates, principally the World Market/Reuters Closing Spot Rates); *In re Barclays Bank PLC*, CFTC No. 15-24 (May 20, 2015) (benchmark currency rates); *In re Barclays Bank PLC*, CFTC No. 15-25 (May 20, 2015) (benchmark currency rates); *In re UBS AG*, CFTC No. 15-06 (Nov. 11, 2014) (same); *In re The Royal Bank of Scotland plc*, CFTC No. 15-05 (Nov. 11, 2014) (same); *In re JPMorgan Chase Bank, N.A.*, CFTC No. 15-04 (Nov. 11, 2014) (same); *In re Citibank, N.A.*, CFTC No. 15-03 (Nov. 11, 2014) (same).

8. See DEP'T OF THE TREAS. J. REP. 1, *supra* note 1.

9. See *U.S. Dealers Slash Treasuries Market-Making - Survey*, Reuters (Oct. 13, 2015), <http://www.reuters.com/article/2015/10/13/usa-bonds-dealers-idUSL1N12D19T20151013> [<https://perma.cc/V32T-DFJN>] (HFTs are driving traditional market makers out of the market); see also, Katy Burne, *The New Bond Market: Algorithms Trump Humans*, WALL ST. J. (Sept. 23, 2015), <http://www.wsj.com/articles/the-new-bond-market-algorithms-trump-humans-1443051304> [<https://perma.cc/JV8C-7L2Y>] (describing concerns with such trading).

agency.¹⁰

II. DEVELOPMENT AND STRUCTURE OF THE TREASURY MARKET

A. Development of the U.S. Treasury Market

Government bonds and other sovereign borrowings were in common use long before the U.S. obtained its independence.¹¹ The American colonies had issued bills of credit to fund their operations, but such debt issuance was sharply curtailed by the English authorities long before the Revolution.¹² Still, a valuable lesson was learned, and the Continental Congress and individual colonies funded the Revolution through the issuance of varying forms of debt securities.¹³ Those issues included the so-called Continental dollar that was used by the Congress to finance the Continental Army until those instruments became virtually worthless as the result of over-issuance and a lack of funding for their redemption.¹⁴

The present U.S. Treasury market was founded on that Revolutionary War debt.¹⁵ After the conclusion of that conflict, Alexander Hamilton convinced Congress to assume the Revolutionary War debts of the Continental Congress and the colonies.¹⁶ That assumption would create a national debt, which Hamilton thought would be a “national blessing” in the funding of government operations, as long as it was “not excessive” in amount.¹⁷

Hamilton’s assumption effort was not without controversy,¹⁸ but a not altogether seemly bargain with its principal opponent, Thomas Jefferson, assured

10. This article is the second in a planned series on consolidating regulation in markets such as foreign currency exchange and mortgage-backed securities. See Jerry Markham, *Regulating the Moneychangers*, 18 U. PA. J. BUS. L. 789, 790 (2016).

11. Government bonds elsewhere in the world were issued as early as 1517 by the government of Amsterdam. VIRENDRA NATH, *OUT OF ACES? FIFTY STEPS TO FINANCIAL ACUITY* 162 (2015).

12. See I JERRY W. MARKHAM, *A FINANCIAL HISTORY OF THE UNITED STATES, FROM CHRISTOPHER COLUMBUS TO THE ROBBER BARONS (1492–1900)* 50–53 (2002) (describing those events).

13. *Id.* at 77.

14. *Id.*

15. *Id.* at 77–78.

16. RON CHERNOW, *ALEXANDER HAMILTON* 328–30 (2004).

17. John Steele Gordon, *Past and Present: Alexander Hamilton and the Start of the National Debt*, U.S. NEWS & WORLD REPORT (Sept. 18, 2008), <http://www.usnews.com/opinion/articles/2008/09/18/past-present-alexander-hamilton-and-the-start-of-the-national-debt> [https://perma.cc/RVB7-3HSN].

18. *Id.*

its passage.¹⁹ Jefferson agreed to withdraw his opposition to Hamilton's assumption program in exchange for Hamilton's support in enacting legislation to move the new nation's capital to Washington, D.C.²⁰

Scandal soon followed after it was discovered that members of Congress, and their merchant friends, on being informed of this bargain, began purchasing the old debt from its unsuspecting owners at steep discounts.²¹ They then tendered the debt for face value when the assumption measure was enacted.²² Such activity was not illegal at the time.²³ However, it occasioned much outrage on the part of Thomas Jefferson who sharply criticized this "base scramble" for profits at the expense of the uninformed.²⁴

Speculation in the U.S. government debt securities that were issued in exchange for the Revolutionary War debt was immediate.²⁵ One speculator, William Duer, who had served as Assistant Secretary of the Treasury under Alexander Hamilton, formed a syndicate called the "Six Percent Club" for the purpose of cornering U.S. government securities that were then paying an interest rate of six percent.²⁶ Such cornering operations seek complete control of a security or commodity so that the perpetrator can dictate prices to other investors.²⁷ That effort failed, however, ruining Duer and sending him to debtor's prison, where he died, causing a national panic in the process.²⁸

19. THOMAS K. MCCRAW, *THE FOUNDERS AND FINANCE* 100–09 (2012).

20. *Id.* at 107–08.

21. MARKHAM, *supra* note 12, at 80.

22. *Id.*

23. At the time there was no legal prohibition against such activity by members of Congress. MARKHAM, *supra* note 12, 80–81. More than 200 years after that event Congress passed the STOCK Act in 2012, which now prohibits such insider trading by members of Congress and their staff. Stop Trading on Congressional Knowledge Act of 2012 (STOCK Act), Pub. L. No. 112-105, 126 Stat. 291.

24. Jefferson charged that:

When the trial of strength had indicated the form in which the bill would finally pass, this being known within doors sooner than without . . . the base scramble began. Couriers and relay horses by land, and swift-sailing boats by sea, were flying in all directions. Active partners and agents were associated and employed in every state, town and country neighborhood; and this paper was bought for five shillings, and even as low as two shillings, in the pound, before the holder knew that congress had already provided for its redemption at par. Immense sums were thus filched from the poor and ignorant, and fortunes accumulated by those who had themselves been poor enough before.

ROBERT IRVING WARSHOW, *ALEXANDER HAMILTON FIRST AMERICAN BUSINESSMAN* 123–24 (1931).

25. MARKHAM, *supra* note 12, at 109.

26. *Id.*

27. *See generally* MARKHAM, *supra* note 5, at 40–41 (describing cornering operations).

28. *See* MARKHAM, *supra* note 12, at 108–11 (describing those events). That debacle occasioned

Despite such abuses, the U.S. treasury market grew and became an important funding source for the government.²⁹ That role became critical during the Civil War, during which the Northern government issued nearly \$3 billion in bonds.³⁰ U.S. government bonds once again proved their value during World War I when Liberty bonds were sold to the public and raised \$18 billion to fund that conflict.³¹ An additional \$150 billion was raised through various bond offerings to fund World War II.³²

In recent times, the U.S. government bond market does much more than fund war operations.³³ Among other things, it is used to fund the seemingly ever-growing national debt, which increased from \$5.6 trillion in 2000 to nearly \$15 trillion in 2014.³⁴

more criticism from Thomas Jefferson:

[A]t length our paper bubble is burst, the failure of Duer in New York soon brought on others, and these still more, like nine pins knocking one another down, till at that place the bankruptcy is become general, every man concerned in paper being broke, and most of the tradesman and farmers, who lend it to them at an interest from 3. to 6. per cent a month, have lost the whole.

WARSHOW, *supra* note 24, at 150.

29. MARKHAM, *supra* note 12, at 114.

30. Many of those bonds were sold to the public through the efforts of Jay Cooke, a financier who would fail spectacularly after the war and cause the Panic of 1873. See MARKHAM, *supra* note 12, at 211–13, 220, 291–93 (describing Cooke's bond sales campaigns and the failure of his firm in 1873).

31. II JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM J.P. MORGAN TO THE INSTITUTIONAL INVESTOR (1900–1970) 76 (2002).

32. *Id.* at 263.

33. *Id.* at 266.

34. *Historical Debt Outstanding—Annual 2000–2015*, TREASURYDIRECT, http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt_histo5.htm [<https://perma.cc/2YN8-EZYT>] (last visited Nov. 21, 2016).

). One leading credit agency, Standard & Poor's downgraded U.S. debt below an AAA rating in 2011. Zachary A. Goldfarb, *S&P Downgrades U.S. Credit Rating for First Time*, WASH. POST (Aug. 6, 2011), http://www.washingtonpost.com/business/economy/sandp-considering-first-downgrade-of-us-credit-rating/2011/08/05/gIQAqKeI_x_story.html [<https://perma.cc/CXU2-QVKJ>]. The growth of the federal deficit has raised political concerns over whether the government will at some point bankrupt itself unless spending is curbed. For example, in one debate between President Barack Obama and former Governor Mitt Romney, the latter charged that the President had vastly increased the national debt during his first term:

We've gone from \$10 trillion of national debt, to \$16 trillion of national debt. If the president were reelected, we'd go to almost \$20 trillion of national debt. This puts us on a road to Greece.

COMMISSION ON PRESIDENTIAL DEBATES, *Oct. 16, 2012 Debate Transcript*, <http://www.debates.org/index.php?page=october-16-2012-the-second-obama-romney-presidential-debate> [<https://perma.cc/KJ2Z-D2ZU>]. Another political concern is the large amount of U.S. debt held by China, which could disrupt U.S. government funding if not renewed. But see Cedric Muhammad, *So What if China Has \$1.32 Trillion in U.S. Treasuries? It Still Can't Crash America's Economy*, FORBES

B. Government Debt Instruments

The modern Treasury market is composed of a number of instruments.³⁵ “Treasury bills” (T-Bills) are short-term debt obligations that “are sold in terms ranging from a few days to 52 weeks. Bills are typically sold at a discount from the par amount (also called face value).”³⁶ “Treasury notes, sometimes called T-Notes, earn a fixed rate of interest every six months until maturity. Notes are issued in terms of 2, 3, 5, 7, and 10 years.”³⁷ “Treasury bonds” operate in the manner as T-Notes except the Treasury bond has a maturity date of thirty years from its issuance.³⁸

The Treasury Department also issues other forms of debt instruments including “floating rate notes” (FRNs) that are “[i]ssued for a term of two years, and pay varying amounts of interest quarterly until maturity.”³⁹ “Interest payments rise and fall based on discount rates in auctions of 13-week Treasury bills.”⁴⁰ Another form of Treasury borrowing is the Treasury Inflation Protected Security (TIPS) that provides protection from the effects of inflation.

(Jan. 16, 2014), <http://www.forbes.com/sites/cedricmuhammad/2014/01/16/so-what-if-china-has-1-32-trillion-in-u-s-treasuries-it-still-cant-crash-americas-economy/#59e1601612de> (discounting such concerns).

35. Another form of U.S. government debt instruments are “agency” debt or guarantees issued by the so-called government sponsored enterprises (GSEs), *e.g.*, Government National Mortgage Association (GNMA), Fannie Mae, and Freddie Mac. These instruments and guarantees are for private loans, particularly residential mortgages. *See* JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM THE SUBPRIME CRISIS TO THE GREAT RECESSION (2006–2009) 377–82 (2011) (describing these GSEs and their debt issuance). Only GNMA instruments were officially guaranteed by the U.S. government until 2008 when Fannie Mae and Freddie Mac were nationalized. *See id.* at 520–23 (describing that nationalization). Fannie Mae and Freddie Mac are regulated separately from the U.S. Treasury market by the Federal Housing Finance Agency. *Id.* at 522. That regulatory structure is outside the scope of this article.

36. *Treasury Bills*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_tbills_glance.htm [<https://perma.cc/FZR6-3NPE>] (last visited Nov. 21, 2016). “For instance, you might pay \$990 for a \$1,000 bill. When the bill matures, you would be paid \$1,000. The difference between the purchase price and face value is interest.”

37. *Treasury Notes*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_tnotes_glance.htm [<https://perma.cc/E49R-XVZ5>] (last visited Nov. 21, 2016).

38. *Treasury Bonds*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_tbonds_glance.htm [<https://perma.cc/U4XJ-UMNV>] (last visited Nov. 21, 2016). The Treasury and private dealers have also sponsored programs that “strip” the interest and principal payments into zero coupon bonds. This “allows the market to restructure payment flows to meet the varying needs of different purchasers.” DEP’T OF THE TREAS. ET AL., J. STAFF REP. ON THE GOV’T SEC. MKT. 1 (Jan. 1992) [hereinafter DEP’T OF THE TREAS. J. REP. 2], <http://www.treasury.gov/resource-center/fin-mkts/Documents/gsr92rpt.pdf> [<https://perma.cc/W2RE-LYCG>].

39. *Floating Rate Notes (FRNs)*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_frns_glance.htm [<https://perma.cc/GS7C-UWPQ>] (last visited Sept. 30, 2015).

40. *Id.*

“The principal of a TIPS increases with inflation and decreases with deflation,⁴¹ as measured by the Consumer Price Index. When a TIPS matures, you are paid the adjusted principal or original principal, whichever is greater.”⁴²

C. Treasury Auctions

“Treasury uses an auction process to sell marketable securities and determine their rate, yield, or discount margin.”⁴³ This process begins with an announcement by the Treasury Department that it will hold auction for a planned issuance of a particular instrument.⁴⁴ This announcement will specify the amount to be issued and the maturity date of the instrument.⁴⁵ Bids in these auctions may be “competitive” or “noncompetitive.”⁴⁶ In a competitive bid, the bidder specifies the rate, yield or discount rate that the bidder will accept.⁴⁷ In a noncompetitive bid, the bidder agrees to accept the rate, yield or discount set at the auction.⁴⁸

The Treasury Department conducts a “Dutch Auction” that sets the rate, yield or spread.⁴⁹ It has described this process as follows:

At the close of an auction, Treasury accepts all noncompetitive bids that comply with the auction rules, and then accepts competitive bids in ascending order in terms of their rates, yields,

41. *Treasury Inflation-Protected Securities (TIPS)*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_tips_glance.htm [<https://perma.cc/S8J6-K4BD>] (last visited Sept. 30, 2015).

42. “TIPS pay interest twice a year, at a fixed rate. The rate is applied to the adjusted principal; so, like the principal, interest payments rise with inflation and fall with deflation.” *Id.* The Treasury Department also issues various forms of savings bonds that can be purchased by individual investors, including Series EE and Series E savings bonds that once paid a variable interest rate but since 2005 new issues of this bond pay a fixed rate. “They are an accrual-type security, which means interest is added to the bond monthly and paid when you cash in the bond.” *Series EE Savings Bonds*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_eebonds_glance.htm [<https://perma.cc/4VMQ-KTRB>] (last visited Sept. 30, 2015). Series I savings bonds provide inflation protection. *Series I Savings Bonds*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_ibonds_glance.htm [<https://perma.cc/JN8R-KN52>] (last visited Sept. 30, 2015). Series HH/H savings bonds “are current-income securities. You paid face value, and receive interest payments by direct deposit to your checking or savings account every 6 months until maturity or redemption.” *HH/H Savings Bonds*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_hhbonds_glance.htm [<https://perma.cc/Y7GJ-768H>] (last visited Sept. 30, 2015).

43. *Auctions*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/products/prod_auctions_glance.htm [<https://perma.cc/A4ER-47DG>] (last visited Nov. 21, 2016).

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. 31 C.F.R. § 356.20 (2014).

or discount margins (lowest to highest) until the quantity of accepted bids reaches the offering amount. All bidders, non-competitive and competitive, will receive the same rate, yield, or spread as the highest accepted bid.⁵⁰

The Treasury security currently being auctioned is said to be “on-the-run,” while its predecessor issue is said to be “off-the-run.”⁵¹ Treasury securities may also be sold on a “when issued” basis prior to an auction, “which helps the market gauge demand and price the securities being offered”⁵²

Treasury auction procedures are governed by a set of rules designed to prevent efforts to manipulate Treasury security prices.⁵³ Among other things, non-competitive bids are limited to \$5 million and competitive bids are limited to thirty-five percent of the auction, less the bidder’s net long position.⁵⁴

Despite that limitation the Treasury auction was the target of a large-scale manipulation in February 1991.⁵⁵ The architect of that scheme was Paul Mozer,⁵⁶ a managing director of Salomon Brothers Inc., a primary dealer that was later acquired by Citigroup, Inc.⁵⁷ Mozer, the head of the firm’s Government Trading Desk, submitted multiple thirty-five-percent bids in dummy names, allowing him to acquire for the firm’s proprietary position, an amount far in excess of the Treasury Department’s thirty-five-percent limitation for any one competitive bidder.⁵⁸

In an auction conducted on February 21, 1991, for \$9 billion, Mozer submitted three bids, each for \$3.15 billion.⁵⁹ One of the bids was for Salomon Brothers and the other two were submitted in the names of two customers of

50. *Auctions*, TREASURYDIRECT, *supra* note 43. This Dutch Auction procedure was adopted by the Treasury in 1974. *Timeline of U.S. Treasury Auctions*, TREASURYDIRECT, https://www.treasurydirect.gov/indiv/research/history/histtime/histtime_auctions.htm [<https://perma.cc/DP2C-MH6G>] (Nov. 21, 2016).

51. In other words:

A Treasury security is “on-the-run” when it is the newest security issue of its maturity (e.g., in October the two-year note issued September 30 would be “on-the-run” while the two-year note issued August 31 would be “off-the-run”). An on-the-run security is normally the most liquid issue for that maturity.

Prop. Treas. Reg. § 375, 64 Fed. Reg. 42626, n. 1 (Aug. 5, 1999).

52. DEP’T OF THE TREAS. J. REP. 2, *supra* note 38, at 1.

53. See 31 C.F.R. § 356 (2014).

54. 31 C.F.R. § 356.22 (2014). The net long position restriction is defined in 31 C.F.R. §356.13 (2014).

55. *United States v. Mozer*, 828 F. Supp. 208, 209 (S.D.N.Y. 1993).

56. *Id.*

57. *In re Gutfreund*, Exchange Act Release No. 34-31554 (Dec. 3, 1992) (by consent).

58. *Mozer*, 828 F. Supp. at 209.

59. *In re Gutfreund*, Exchange Act Release No. 34-31554 (Dec. 3, 1992) (by consent).

Salomon Brothers, i.e., the Quantum Fund and Mercury Asset Management.⁶⁰ However, those customers had not authorized the bids and were unaware that they were submitted in their names.⁶¹ The bids were prorated, but this scheme still allowed Salomon Brothers to acquire almost fifty-seven percent of the auction.⁶²

An affiliate of Mercury Asset Management that was a primary dealer had submitted a bid in the auction that, when combined with the Mercury bid submitted by Mozer, put it over the thirty-five-percent limitation.⁶³ This led to an inquiry by the Treasury Department, which eventually resulted in the unraveling of Mozer's scheme.⁶⁴

Mozer then advised Salomon Brothers senior management of this inquiry and of his false bids.⁶⁵ Those executives did nothing for several months, and Mozer employed this scheme in two subsequent Treasury auctions before the firm reported his conduct.⁶⁶ Those executives were sanctioned by the Securities and Exchange Commission (SEC) for failing to supervise Mozer and for delaying the report of his conduct after it was first brought to their attention.⁶⁷ Mozer pleaded guilty to criminal charges and was sentenced to four months in prison and fined \$30,000. He also settled SEC charges by paying a \$1 million civil penalty.⁶⁸

Salomon Brother's large purchases raised concerns that it had engendered a "short squeeze," i.e., a situation in which there is a shortage of securities for short sellers to cover their positions, causing them to pay higher prices for those securities.⁶⁹ This was alleged to have occurred in instances where Salomon

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. Keith Bradsher, *Former Salomon Trader to Pay \$1.1 Million Fine*, N.Y. TIMES (Jul. 15, 1994), <http://www.nytimes.com/1994/07/15/business/former-salomon-trader-to-pay-1.1-million-fine.html> [<https://perma.cc/ABQ2-E2CV>].

69. A short squeeze has been defined as follows:

When one market participant, or a group of market participants acting in concert, manages to purchase a significant proportion of the available supply of a particular security, that single participant or group is said to have "cornered the market[.]" When that happens, the single participant or group can withhold the securities from the market and at the same time demand the return of any securities that they have loaned to short sellers. In such a situation, the short sellers

Brothers bought up a larger percentage of Treasury auctions than permitted by Treasury auction rules.⁷⁰ However, a private action seeking damages for that conduct was dismissed because the plaintiffs could not show how they were damaged by such conduct.⁷¹

In a separate action the SEC charged that Steinhardt Management Co. and Caxton Corp. had established leveraged long positions in April 1991, two-year cash Treasury notes.⁷² Their combined positions constituted over 158 percent of the approximately \$12 billion in notes that were issued in that auction.⁷³ This squeezed traders that had sold short to Steinhardt and Caxton.⁷⁴ Those short sellers had to make delivery by borrowing notes in the repo market or by buying notes in the cash market in which Caxton and Steinhardt held controlling positions.⁷⁵ This forced the short sellers to pay artificial prices to Steinhardt and Caxton. Settlement was reached and the respondents agreed jointly to pay \$76 million in fines and disgorgement of profits.⁷⁶

Following the Salomon Brothers scandal, Treasury changed some of its auction procedures. Legislation that was passed in 1975 also authorized Treasury to require large traders in Treasury securities to report their positions.⁷⁷ However, this did not end concerns over the manipulation of Treasury auction prices. In 2015, the CFTC and Department of Justice began far ranging investigations into the conduct of the prime dealers in order to determine if they were manipulating auction prices.⁷⁸ The New York State Department of Financial Services regulator also subpoenaed nine large banks seeking information on their Treasury auction activities.⁷⁹ The regulators were seeking to determine if the large banks and other prime dealers were artificially depressing Treasury

must purchase or borrow the securities in order to redeliver them to those controlling the securities, driving up the price of the securities and, presumably, increasing the profits of the single participant or group that controls the securities.

DEP'T OF THE TREAS. J. REP. 2, *supra* note 38, at C-5-C-6 (footnote omitted).

70. *Id.* at C-6.

71. *Three Crown Ltd. P'ship. v. Salomon Bros.*, 906 F. Supp. 876, 890-91 (S.D.N.Y. 1995).

72. *SEC v. Steinhardt Mgmt. Co.*, Litig. Release No. 14358, 58 SEC Docket 1307, No. 6 (Dec. 16, 1994).

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. Government Securities Act Amendments of 1993, Pub. L. No. 103-202, 107 Stat. 2344.

78. Aruna Viswanatha, Justin Baer & Katy Burne, *Probe Widens Into Treasury Debt Auctions*, WALL ST. J. (Nov. 3, 2015), <http://www.wsj.com/articles/probe-widens-into-treasury-debt-auctions-1446596472> [<https://perma.cc/KE9W-MJUQ>].

79. *Id.*

prices in order to allow them to profit on other positions.⁸⁰ This probe followed massive settlements with regulators totaling \$9 billion by many of those same banks concerning charges that they had manipulated the Libor and other benchmark interest rates.⁸¹ In other settlements, these banks paid \$10 billion to settle government charges that they manipulated foreign currency exchange prices.⁸²

D. Secondary Market

The value of Treasury securities after being auctioned will fluctuate as interest rates change or economic conditions, such as inflation or recession, affect their value. This has resulted in the development of a secondary market in these securities.⁸³ Traders may seek profits from such fluctuations. This secondary market is also important to the Fed's efforts to control interest rates through its open market operations.⁸⁴ These operations are the responsibility of the Federal Open Market Committee (FOMC), which has twelve voting members, i.e., the seven Fed members, plus the president of the New York Fed and four of the other eleven regional Fed presidents on a rotating basis.⁸⁵ The FOMC oversees "the Fed's buying and selling of government securities, the primary tool through which the Fed determine[s] short-term interest rates and influence[s] the money supply."⁸⁶

80. *Id.*

81. Jeffrey Vögel & Hugo Miller, *Deutsche Bank Libor Damage Goes Beyond Record \$2.5 Billion Fine*, BLOOMBERG (Apr. 23, 2015), <http://www.bloomberg.com/news/articles/2015-04-23/deutsche-bank-libor-damage-goes-beyond-record-2-5-billion-fine> [<https://perma.cc/V23K-EUZX>].

82. See Chiara Albanese, David Enrich & Katie Martin, *Citigroup, J.P. Morgan Take Brunt of Currencies Settlement*, WALL ST. J. (Nov. 12, 2014), <http://www.wsj.com/articles/banks-reach-settlement-in-foreign-exchange-rigging-probe-1415772504> [<https://perma.cc/4ZGX-WAVH>]; Michael Corkery & Ben Protess, *Rigging of Foreign Exchange Market Makes Felons of Top Banks*, N.Y. TIMES (May 20, 2015), <http://www.nytimes.com/2015/05/21/business/dealbook/5-big-banks-to-pay-billions-and-plead-guilty-in-currency-and-interest-rate-cases.html> [<https://perma.cc/YD6U-3YTL>] (describing those settlements).

83. See generally DEP'T OF THE TREAS. J. REP. 1, *supra* note 1, at 2.

84. See BEN S. BERNANKE, THE COURAGE TO ACT, A MEMOIR OF A CRISIS AND ITS AFTERMATH 379 (2015) (Treasury securities are "routinely bought and sold . . . as part of normal [Fed] monetary policy operations").

85. *Id.* at 48.

86. *Id.* As the Fed has described those operations:

Open market operations (OMOs)—the purchase and sale of securities in the open market by a central bank—are a key tool used by the Federal Reserve in the implementation of monetary policy. Historically, the Federal Reserve has used OMOs to adjust the supply of reserve balances so as to keep the federal funds rate around the target federal funds rate established by the Federal Open Market Committee (FOMC). OMOs are conducted by the Trading Desk at the Federal Reserve Bank of New York.

The secondary market for Treasury securities provides other important functions. For example, its prices are benchmarks for other assets.⁸⁷ This is because Treasury securities are viewed as setting the risk-free rate for lending.⁸⁸ Non-U.S. Treasury securities will pay a higher return than a Treasury security of the same tenor. That premium is based on the amount of risk of default of the non-Treasury instrument over that of the U.S. government.⁸⁹ The secondary market in Treasury securities also acts as a source of liquidity for short-term working capital for many large businesses and is a popular source of collateral for the multi-trillion-dollar tri-party repo market.⁹⁰

Open Market Operations, BD. OF GOVERNORS OF THE FED. RES. SYS., http://www.federalreserve.gov/monetarypolicy/bst_openmarketops.htm [<https://perma.cc/L2CQ-PS63>] (last updated May 2, 2016).

87. DEP'T OF THE TREAS. J. REP. 1, *supra* note 1, at 1.

88. *Id.*

89. *Id.*

90. Tracy Alloway, *Big Investors Replace Banks in \$4.2tn Repo Market*, FIN. TIMES (LONDON) (May 29, 2014), <http://www.ft.com/intl/cms/s/0/ca529c5e-e5db-11e3-aeef-00144feabdc0.html#axzz3nnZVo500>. As the Fed has described the repo market:

A repo is the sale of a security, or a portfolio of securities, combined with an agreement to repurchase the security or portfolio on a specified future date at a prearranged price. Aside from some legal distinctions concerning bankruptcy treatment, a repo is similar to a collateralized loan . . . For the opening leg of the repo, an institution with cash to invest, the cash provider, purchases securities from an institution looking to borrow cash, the collateral provider.

....

In most segments of the U.S. repo market, at least one of the counterparties is a securities dealer. Dealers use the repo market to finance their inventories of securities, among other purposes. In some cases, the collateral provider is a client of the dealer that wants to borrow cash. On these repos, the dealer is the cash provider. Repos involve a variety of other cash providers, including money market funds (MMFs), asset managers, securities lending agents, and investors looking to obtain specific securities as collateral in order to hedge or speculate based on changes in the market values of those securities.

Adam Copeland, et al., *Key Mechanics of the U.S. Tri-Party Repo Market*, FRBNY ECONOMIC POLICY REVIEW, <http://www.newyorkfed.org/research/epr/2012/1210cope.pdf> [<https://perma.cc/5Y8X-VL8D>] (forthcoming) (manuscript at 2) (last visited Nov. 21, 2016) (footnotes omitted). An important part of the tri-party repo market is the role of a clearing bank:

These clearing banks play a number of important roles as intermediaries. They take custody of the securities involved in the repo, value the securities and make sure that the specified margin is applied, settle the transaction on their books, and offer services to help dealers optimize the use of their collateral. The clearing banks do not, however, match dealers with cash investors, nor do they play the role of broker in that market.

To give dealers access to their securities during the day, the clearing banks settle all repos early each day, returning cash to cash investors and collateral to dealers. Because of the delay in settlement, the clearing banks wind up extending hundreds of billions of intraday credit to the dealers until new repos are settled in

The secondary market for U.S. Treasury securities is “one of the world’s largest and most liquid financial markets.”⁹¹ Over \$500 billion in treasury securities are purchased and sold daily.⁹² It is a “virtual round-the-clock market” that operates with trade sizes of \$1 million for Treasury notes and \$5 million for Treasury bills.⁹³ Most Treasury securities are traded electronically and, like other securities markets, have been the subject of high-frequency traders who use algorithms to try and take advantage of even small price fluctuations.⁹⁴

Trading in the secondary market “takes place between primary dealers, nonprimary dealers, and customers of these dealers, including financial institutions, nonfinancial institutions, and individuals.”⁹⁵ At the center of the market are a small number of “interdealers” who provide other dealers with quotes showing the best bid and offer prices among the dealers for particular Treasury

the evening.

Lucinda Brickler, Adam Copeland & Antoine Martin, *Everything You Wanted to Know about the Tri-party Repo Market, but Didn't Know to Ask*, FED. RES. BANK OF N.Y.: LIBERTY STREET ECONOMICS (APR. 11, 2011, 10:00 AM), <http://libtystreeteconomics.newyorkfed.org/2011/04/everything-you-wanted-to-know-about-the-tri-party-repo-market-but-didnt-know-to-ask.html#.VR1lylzfAY> [https://perma.cc/5CGB-V4A6]. JPMorgan announced in 2016 that it was exiting the business of clearing government security transactions, leaving only one bank, BNY Mellon, to carry out that function. Eric Thayer, *JPMorgan to Stop Settling Government Securities for Dealers*, REUTERS (July 22, 2016), <http://www.reuters.com/article/us-jpmorgan-settlement-idUSKCN1021VK> [https://perma.cc/UR7M-XTSU].

91. Michael J. Fleming, *The Round-The-Clock Market for U.S. Treasury Securities*, FRBNY ECONOMIC POLICY REVIEW 9 (July 1997), <http://www.newyorkfed.org/research/epr/97v03n2/9707flem.pdf> [https://perma.cc/V4AN-S37P]. Concerns have arisen over whether this market is becoming less liquid as a result of changed regulatory requirements and Fed actions. Liz Capo McCormick & Daniel Kruger, *The Treasury Market's Legendary Liquidity Has Been Drying Up*, BLOOMBERG (Feb. 1, 2015), <http://www.bloomberg.com/news/articles/2015-02-02/if-trading-bonds-is-hard-think-about-the-pain-when-rates-rise> [https://perma.cc/GQ8K-9WVC].

92. Thayer, *supra* note 90.

93. Fleming, *supra* note 91, at 9.

94. *Automated Trading in Treasury Markets*, TREASURY MARKET PRACTICES GROUP (June 2015), <https://www.newyorkfed.org/TMPG/medialibrary/microsites/tmpg/files/TPMG-June-2015-Automated-Trading-White-Paper.pdf> [https://perma.cc/5QW2-S8QB].

95. Dominique Dupont & Brian Sack, *The Treasury Securities Market: Overview and Recent Developments*, FED. RES. BULL. 789 (December 1999), <http://www.federalreserve.gov/pubs/bulletin/1999/1299lead.pdf> [https://perma.cc/3VMV-VETY]. As one court has noted:

Secondary dealers are to be distinguished from primary dealers who purchase securities directly from the Federal Reserve. Savings and loan associations and local governments make up a significant number of customers engaging in repo transactions with secondary dealers. Other customers include money market and mutual funds, pension funds, insurance, financial and other corporations, and foreign investors.

In re Bevil, Bresler & Schulman Asset Mgmt. Corp., 878 F.2d 742, 743 (3d Cir. 1989).

securities.⁹⁶ The primary dealers are the most active participants in this secondary market.⁹⁷

Treasury securities transactions in the secondary market are conducted across multiple venues, including interdealer trading on electronic trading platforms and dealer-to-customer trades on a bilateral basis electronically or by voice orders.⁹⁸ Market makers provide liquidity to this market. As a Fed publication notes:

Many dealers, particularly the primary dealers, “make markets” in Treasury securities by standing ready to buy and sell securities at specified prices. In the process of making markets, dealers purchase securities at the bid price and sell the same securities at a slightly higher price, the offer price. Through these sales and purchases, the dealer can facilitate transactions between customers while taking only temporary positions in the security. In doing so, the dealer earns the difference between the bid and offer prices, referred to as the bid-offer spread.⁹⁹

III. REGULATORY STRUCTURE

A. Banking and SEC Regulatory Jurisdiction

Regulatory jurisdiction over the Treasury market has been allocated among several regulators, including the Treasury, the Fed, the New York Fed, other “appropriate” banking regulators, and the SEC.¹⁰⁰ As described above, the Treasury conducts and regulates the auctions for the issuance of U.S. Treasury securities.¹⁰¹ The Fed and New York Fed conduct open market operations for adjusting the money supply through the primary dealers appointed by the New

96. Dupont & Sack, *supra* note 95, at 789.

97. *Id.* at 785.

98. DEP’T OF THE TREAS. J. REP. 1, *supra* note 1, at 11.

99. Dupont & Sack, *supra* note 95, at 789.

100. DEP’T OF THE TREAS. J. REP. 2, *supra* note 38, at 3.

101. As one government report has noted:

Compliance and enforcement responsibility for the auction rules rests with the Treasury. The Treasury may bar or suspend a firm from auctions, and the Treasury reserves the right to reject bids in auctions. However, the Securities and Exchange Commission (“SEC”), the Treasury, and the self-regulatory organizations (“SROs”) are not authorized to examine government securities firms for compliance with Treasury auction rules.

DEP’T OF THE TREAS. J. REP. 2, *supra* note 38, at xi. The Fed works with Treasury to check Treasury auction bids for authenticity. *Id.* at xiii.

York Fed and other market participants.¹⁰²

U.S. Government securities are treated as “exempt” securities under the Securities Act of 1933, which means that they did not have to be registered with the SEC.¹⁰³ However, exempt securities are subject to SEC antifraud rules.¹⁰⁴ Until 1986, dealers in exempt securities were not required to register with the SEC.¹⁰⁵ That situation changed, however, after a number of scandals arose in the 1980s involving government securities sales and repo transactions involving government securities. Between 1975 and 1985, failures of government bond dealers caused losses of nearly \$1 billion. Most of those losses were associated with repo transactions.¹⁰⁶

Drysdale Government Securities was one such failure. In 1982, it defaulted on \$279 million in payments due to repo customers.¹⁰⁷ The failure of Bevell, Bresler & Schulman Asset Management Corp., another repo dealer, resulted in losses of \$150 million in 1985.¹⁰⁸ The bankruptcy of E.S.M. Government Securities (“ESM”), a repo dealer based in Fort Lauderdale, Florida, resulted in losses of some \$250 million.¹⁰⁹ The collapse of ESM also caused the failure of

102. *Id.* at x. After the Salomon Brothers auction scandal regulation of the primary dealers was changed so that

direct regulatory authority over primary dealers will rest unambiguously with the primary regulator - in most cases, the SEC. Although the FRBNY has no statutory authority to regulate the primary dealers, the primary dealer system may have generated the false impression in the marketplace that the FRBNY somehow regulates or takes responsibility for the conduct of primary dealers. To make clear that its relationship with the primary dealers is solely a business relationship, the FRBNY will eliminate its dealer surveillance program, while upgrading its market surveillance program

Id. at xv.

103. 15 U.S.C. § 77c(a)(2) (2012).

104. DEP’T OF THE TREAS. J. REP. 2, *supra* note 38, at xi.

105. James B. Burnham, *The Government Securities Act of 1986, A Case Study of the Demand for Regulation*, REGULATION 78 (SUMMER 1990). <http://object.cato.org/sites/cato.org/files/serials/files/regulation/1990/7/v13n2-9.pdf> (last visited Nov. 21, 2016) [<https://perma.cc/V8SK-279Z>].

106. III JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES, FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM (1970–2001) 104 (2002).

107. Michael Quint, *Lessons in Drysdale’s Default*, N.Y. TIMES, May 20, 1982, at D1, <http://www.nytimes.com/1982/05/20/business/lessons-in-drysdale-s-default.html> [<https://perma.cc/V9M9-XVCT>].

108. James Sterngold, *Loss at Bevell, Bresler Unit Is Put at \$150 Million*, N.Y. TIMES, (Oct. 24, 1985), <http://www.nytimes.com/1985/10/24/business/loss-at-bevell-bresler-unit-is-put-at-150-million.html> [<https://perma.cc/A65W-JN2Y>].

109. Michael Quint, *E.S.M. Collapse: A Lesson in Safety*, N.Y. TIMES, (Mar. 8, 1985), <http://www.nytimes.com/1985/03/08/business/esm-collapse-a-lesson-in-safety.html> [<https://perma.cc/P74M-GCGN>].

the Home State Savings Bank in Cincinnati, Ohio.¹¹⁰ The failure of Home State exhausted the Ohio thrift insurance fund and set off a run on other savings and loan associations.¹¹¹ This caused the governor of Ohio to suspend the operations of all state thrift associations until they could obtain federal insurance.¹¹²

The Government Securities Act of 1986 (GSA) was passed in response to these failures.¹¹³ “Financial institutions,” such as banks, that acted as dealers in government securities were subjected to regulation by the “appropriate regulatory agency.”¹¹⁴ Non-banks acting as dealers in such securities were required to register with the SEC or to give notice of such activity if already registered with the SEC as a broker-dealer.¹¹⁵ Treasury was directed by the GSA to adopt rules to govern the operations of government securities dealers and brokers, including those registered with the SEC.¹¹⁶

The SEC regulated automated trading systems (ATS) by requiring them to register as broker-dealers.¹¹⁷ That requirement subjected those electronic trading platforms to the full panoply of SEC regulations that govern nearly every aspect of a broker-dealer’s operations.¹¹⁸ However, ATS’s trading only U.S. government securities was exempted from that registration requirement and hence also from other SEC rules governing broker-dealers.¹¹⁹

B. CFTC Jurisdiction

Treasury market debt instruments are the subject of trading in derivative instruments in the commodity markets, including futures, options, and swaps.¹²⁰ The Commodity Exchange Act of 1936 (“CEA”) granted the CFTC exclusive jurisdiction over futures contracts on U.S. government securities, as well as

110. Associated Press, *3 Convicted in Failure of Home State*, N.Y. TIMES, (Mar. 3, 1987), <http://www.nytimes.com/1987/03/03/business/3-convicted-in-failure-of-home-state.html> [<https://perma.cc/93HX-UGWS>].

111. *Id.*

112. *Id.*

113. Gov’t Sec. Act (GSA) of 1986, Pub. L. No. 99-571, 100 Stat. 3208.

114. 15 U.S.C. § 78o-5(a) (2012).

115. *Id.*

116. 15 U.S.C. § 78o-5(b) (2012).

117. See Jerry W. Markham & Daniel J. Harty, *For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs*, 33 IOWA J. CORP. L. 865, 911 (2008) (describing the background and nature of that regulation).

118. *Id.*

119. 17 C.F.R. § 242.301(a)(4)(ii) (2016).

120. See generally CFTC, *International Monetary Fund—Financial Sector Assessment Program Self Assessment of IOSCO Objectives and Principles of Securities Regulation* 4 (Aug. 2009).

other commodities that are traded on exchanges registered with that agency.¹²¹ The CFTC has authority to bring manipulation charges where the price of a futures contract or its underlying commodity is manipulated.¹²² The CFTC also has authority to police abusive trading activities on the commodity exchanges such as wash sales, fictitious trades, and "spoofing."¹²³

The Treasury futures market on the floor of the Chicago Board of Trade (CBOT) was the subject of a bizarre fraud scheme by a group of individuals in 1988.¹²⁴ They used wigs and other disguises, as well as fake trading credentials, to gain access to the Treasury bond pit for a period of about one year.¹²⁵ Through the use of those disguises they were able to make risk free trades by claiming profitable trades and ignoring unprofitable trades.¹²⁶

An almost equally bizarre effort to manipulate the Treasury market on the CBOT occurred in 1992, an affair that was conducted by two individuals who tried to use the principles of mass psychology to manipulate the market.¹²⁷ They would do this by selling large amounts of options and futures, which would cause other traders to sell in the belief that the market was in decline.¹²⁸ That reaction in turn drove the market down further, and the conspirators then covered their positions at a profit.¹²⁹ The conspirators were able to access the services of a CBOT clearing firm by misrepresenting their finances and by presenting a large worthless check.¹³⁰ They also obtained CBOT memberships, all of which were needed to allow them to trade on the floor. They began their scheme on October 21, 1992, and made \$1 million within a frame of a few minutes of trading.¹³¹ However, the scheme quickly fell apart when exchange officials questioned what they were doing. The conspirators were then forced to liquidate their positions with a loss of \$8.5 million, which destroyed their clearing firm.¹³² One of the conspirators fled to Canada, and the other was convicted of fraud and sentenced to forty-two months imprisonment.¹³³

121. *Id.* at 11.

122. See MARKHAM, *supra* note 5, at 57-92, 325-31 (describing that authority).

123. *Id.* at 331-38 (describing that authority). Spoofing involves placing orders that the trader intends to cancel before they can be executed. *Id.* at 338.

124. *United States v. Sanders*, 893 F.2d 133, 135 (7th Cir. 1990).

125. *Id.* at 136.

126. *Id.* at 138.

127. *United States v. Catalfo*, 64 F.3d 1070, 1072 (7th Cir. 1995).

128. *Id.*

129. *Id.*

130. *Id.* at 1073-74.

131. *Id.* at 1074-75.

132. *Id.* at 1075-76.

133. *Id.* at 1076.

In another action that was settled by consent, the CFTC found that the respondent had engaged in manipulation of the prices of the June 1993, ten-year U.S. Treasury note futures contract that was traded on the CBOT.¹³⁴ The respondent was found to have engaged in that manipulation by obtaining a dominant portion of the available supply of the cheapest delivery Treasury notes for the June futures contract.¹³⁵ The respondent also entered into repo transactions that further tightened available supplies, and it withheld its notes from the market.¹³⁶ This required the shorts to deliver more expensive Treasury securities.¹³⁷

Another case involved charges that Pacific Investment Management Co., LLC (PIMCO), manipulated the Treasury market in futures for ten-year Treasury notes in May and June 2005. The Seventh Circuit upheld the district court's certification of a class action for investors in those notes, allowing them to pursue claims that PIMCO violated the anti-manipulation provisions of the CEA.¹³⁸ This action was later settled for \$92 million.¹³⁹

In *In re Murphy*,¹⁴⁰ the CFTC considered a trading practice known as a "ginzy" involving futures contracts for United States Treasury Bonds on the CBOT.¹⁴¹ The traders involved in those transactions were seeking to avoid the minimum price fluctuation requirement (ticks) of one thirty-second of one percent.¹⁴² Because of changes in the tax laws, the nature of the trading in the futures contract changed, making smaller minimum ticks desirable.¹⁴³ Local floor traders then devised the ginzy, in which a local trader traded against part of a floor broker's customer order at a disadvantageous price, with the understanding that the floor trader would participate at a more favorable price in the remainder of the same order.¹⁴⁴ The CFTC found that such trading was non-competitive in violation of the CEA's prohibition against such activity.¹⁴⁵

A trader on the CBOT, David G. Sklena, made \$1.65 million in profits

134. *In re Fenchurch Capital Mgmt., Ltd.*, CFTC No. 96-7, Comm. Fut. L. Rep. (CCH) ¶ 26, 747 (Jul. 10, 1996).

135. *Id.*

136. *Id.*

137. *Id.*

138. *Kohen v. Pac. Inv. Mgmt. Co.*, 571 F.3d 672, 674, 680 (7th Cir. 2009).

139. Sree Vidya Bhaktavatsalam, *Pimco to Pay \$92 Million to Settle Market Manipulation Lawsuit*, BLOOMBERG (Dec. 30, 2010), <http://www.bloomberg.com/news/articles/2010-12-30/pimco-to-pay-92-million-to-settle-futures-lawsuit> [https://perma.cc/87W6-8EPT].

140. *In re Murphy*, CFTC No. 82-37, Comm. Fut. L. Rep. (CCH) ¶ 22, 798 (Sept. 25, 1985).

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.*

through trading in the five-year Treasury note futures on April 2, 2004.¹⁴⁶ He made those profits by using the volatility caused by better-than-expected employment numbers to disguise noncompetitive trades that ripped off customers.¹⁴⁷ Sklena was subsequently convicted of criminal charges for defrauding customers and manipulating prices.¹⁴⁸

In still another case, *In re Moster*,¹⁴⁹ the CFTC found by consent that a trader for Bank of America had booked fictitious trades that inflated the value of his trading book in Treasury futures by over \$12 million.¹⁵⁰ Still another example of prohibited fictitious trading is found in *In re BlackRock Institutional Trust Co.*,¹⁵¹ a CFTC administrative proceeding where it was found by consent that employees of Blackrock and JPMorgan entered into prearranged fictitious trades of Treasury note futures spreads.¹⁵² The orders were entered through different brokerage firms about one minute apart, were intended to meet and match each other, and were structured to achieve that effect.¹⁵³

The Treasury market was the subject of an insider trading scandal after it was discovered that, on October 31, 2001, Peter J. Davis, a consultant for Goldman Sachs, provided John M. Youngdahl, a Goldman Sachs employee with non-public information contained in an embargoed Treasury announcement.¹⁵⁴ Davis also tipped the Massachusetts Financial Services Co. with that information.¹⁵⁵ The non-public information was that Treasury was discontinuing the thirty-year Treasury bond, which would increase the value of the remaining outstanding thirty-year bonds.¹⁵⁶ Youngdahl made large purchases of thirty-year bonds before the public announcement of its discontinuance, as did the Massachusetts Financial Services Co.¹⁵⁷ These players were all sanctioned by the SEC by consent and Youngdahl pleaded guilty to criminal charges and was sentenced to thirty-three months in prison.¹⁵⁸ However, class action and other claims over charges that this conduct violated the anti-manipulation provisions

146. *United States v. Sklena*, 692 F.3d 725, 727 (7th Cir. 2012).

147. *Id.*

148. *See United States v. Sklena*, No. 09 CR 302, at 1 (N.D. Ill. May 9, 2011).

149. *In re Moster*, CFTC No. 09-08, Comm. Fut. L. Rep. (CCH) ¶ 31, 314 (Feb. 11, 2009).

150. *Id.*

151. *In re BlackRock Inst. Co.*, CFTC No. 12-13, Comm. Fut. L. Rep. (CCH) ¶ 32, 143 (Mar. 8, 2012).

152. *Id.*

153. *Id.*

154. *Premium Plus Partners, L.P. v. Goldman, Sachs & Co.*, 648 F.3d 533, 534 (7th Cir. 2011).

155. Complaint ¶ 1, *SEC v. Davis*, No. 03-cv6672 (S.D.N.Y. Sept. 4, 2003).

156. 648 F.3d at 534.

157. Complaint, *supra* note 155, ¶¶ 5-6, 9.

158. 648 F.3d at 534.

of the CEA were rejected and then settled for a small amount.¹⁵⁹

Treasury bond futures have also been associated with some old-fashioned retail customer fraud. In *CFTC v. Liberty Financial Trading Corp.*,¹⁶⁰ a district court, by consent, enjoined the defendants who had been making false statements in soliciting customers in trading Treasury bond put options.¹⁶¹ Customers were told they would double their money because the war in Iraq would lead to a rise in the stock market and a corresponding drop in the value of Treasury bonds.¹⁶² The firm failed to disclose that over ninety percent of its customers had lost money.¹⁶³

C. U.S. Treasury Market Volatility on October 15, 2014

Volatility in the U.S. Treasury market on October 14, 2014, led to a study by multiple agencies of that event and a governmental review of the adequacy of regulation over this market.¹⁶⁴ The report resulting from that study (the Joint Study) found that the market for U.S. Treasury securities, futures, and other closely related financial markets experienced an unusually high level of volatility on that day.¹⁶⁵ “Although trading volumes were high and the market continued to function, liquidity conditions became significantly strained.”¹⁶⁶ The ten-year Treasury note experienced a highly unusual thirty-seven-basis-point up-and-down trading range.¹⁶⁷ “Intraday changes of greater magnitude have been seen on only three occasions since 1998 and, unlike October 15, all were driven by significant policy announcements.”¹⁶⁸

The Joint Study determined that volatility on October 15, 2014, was unconnected with any significant policy announcement and was concentrated in a twelve-minute period.¹⁶⁹ “For such significant volatility and a large round-trip in prices to occur in so short a time with no obvious catalyst is unprecedented

159. *Id.* at 535.

160. *CFTC v. Liberty Fin. Trading Corp.*, No. 04-61235, Comm. Fut. L. Rep. (CCH) ¶ 30, 501 (S.D. Fla. 2007).

161. *Id.* at 1–2, 5.

162. *Id.* at 7.

163. *Id.* at 8.

164. See generally DEP’T OF THE TREAS. J. REP. 1, *supra* note 1. This study was conducted by the staffs of the Treasury, the Fed, New York Fed Bank, the SEC, and CFTC. *Id.*

165. *Id.* at 1.

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.* at 8.

in the recent history of the Treasury market.”¹⁷⁰ Market liquidity also experienced a “dramatic decline” in the hour that proceeded twelve minutes of unusual volatility.¹⁷¹ Market depth, as measured by standing quotes in order books, declined and transaction costs increased even though trading volume reached record highs.¹⁷²

The Joint Study observed that a small number of principal trading firms (PTFs), i.e., firms trading for their own accounts, accounted for most of the trading activity of those firms.¹⁷³ The Joint Study also observed that the growth in HFTs was allowing PTFs to account for a majority of trading volume in the market and to provide “the vast majority of market depth.”¹⁷⁴ This market dominance by PTFs was supplanting the historical dominance of bank-dealers in the interdealer Treasury market.¹⁷⁵ Derivatives trading by PTFs was also shifting the center of the Treasury market from New York to Chicago.¹⁷⁶

On October 15, 2014, PTFs accounted for more than fifty percent of trading volume in both the Treasury cash and futures markets and bank dealers were responsible for some thirty to forty percent of volume.¹⁷⁷ This trading was further concentrated in the most active PTFs and bank dealers.¹⁷⁸ However the Joint Study’s analysis of data on these and other traders did not reveal a single cause for the extraordinary volatility on October 15, 2014.¹⁷⁹ The Joint Study did note that the growth of electronic trading had transformed the Treasury market’s participants.¹⁸⁰ Among other things it gave rise to dominance in trading

170. *Id.* at 1.

171. *Id.* at 3. Liquidity was defined by the joint study of this event “as the cost associated with executing a trade.” *Id.* The Joint Study also stated that:

Another manner in which liquidity might be viewed is across an immediacy spectrum. Through that lens, liquid markets are those where participants *are able to continuously* transact even if there is little market depth and prices are very responsive to incoming orders to buy or sell securities.

Id. at 8.

172. *Id.* at 3.

173. *Id.* at 4.

174. *Id.* at 6.

175. *Id.*

176. Susanne Barton, *Chicago Speed Firms Battle Wall Street for Bond Sway*, BLOOMBERG (Oct. 25, 2015), www.bloomberg.com/news/articles/2015-10-25/treasuries-epicenter-tilts-toward-chicago-with-high-speed-firms.

177. DEP’T OF TREAS. J. REP. 1, *supra* note 1, at 21.

178. *Id.* at 22.

179. *Id.* at 33.

180. The Joint Study noted that:

Until 1992, . . . the interdealer brokers only allowed primary dealers, as designated by the Federal Reserve Bank of New York, to access their trading platforms. In 1992, the interdealer brokers expanded access to all entities that were

to the PTFs and that trading was concentrated in a small number of firms.¹⁸¹

Electronic trading also raised questions about evolving risks in the Treasury market.¹⁸² Those risks include operational risks from malfunctioning algorithms; market liquidity risks from abrupt changes in market trading strategies; market integrity risks from price manipulations; transmission risks from erroneous cross-market orders; clearing and settlement risks from bi-lateral, non-centrally cleared trades; and risk management risks from the inability to protect against unexpected margin demands from HFT.¹⁸³

The Joint Study recommended further study of the evolution of the U.S. Treasury market.¹⁸⁴ It also recommended the strengthening of monitoring and surveillance of the market and the promotion of inter-agency coordination related to the regulation of this market.¹⁸⁵ In furtherance of those recommendations, on October 2015, the SEC, CFTC, and bank regulators met to consider whether additional regulation was needed to assure the integrity of the Treasury market.¹⁸⁶ The SEC Chair announced that the SEC was considering whether a registration requirement should be imposed on ATS trading U.S. government securities.¹⁸⁷ The Chair of the CFTC stated that his agency was also considering registration requirements for firms dealing in derivatives on U.S. Treasury securities.¹⁸⁸ Additionally, the CFTC was considering requiring “pre-trade risk controls such as ‘message throttles’ and maximum order size limits . . . [and] new requirements for the design, testing and supervision of automated trading

netting members of the Government Securities Clearing Corporation (now the Fixed Income Clearing Corporation, or FICC). Over time, other entities gained access to the platforms through their prime brokers, who themselves had access, and the platforms in recent years granted direct access to an even wider range of participants, including those outside the FICC netting membership. In particular, PTFs gained access to the platforms in the mid-2000s.

Id. at 35–36.

181. *Id.* at 36.

182. *Id.*

183. *Id.* at 54–55.

184. *Id.* at 45.

185. *Id.*

186. Katy Burne, *Regulators Weigh Treasury Rules*, WALL ST. J., Oct. 21, 2015, at C2, <http://www.wsj.com/articles/secs-mary-jo-white-urges-review-of-treasury-trading-venue-rules-1445362332> [<https://perma.cc/HC3P-H5LF>].

187. *Id.*

188. Gregory Meyer & Joe Rennison, *US Regulator Signals First Moves to Rein in Risks of High-Speed Trading: *CFTC seeks to avoid ‘flash events’ *Proposals include ‘kill switches’ and order limits*, FIN. TIMES (LONDON), Oct. 22, 2015, at 1.

systems and ‘kill switches,’ which shut down runaway algorithms.”¹⁸⁹ Still another proposal would require dealers to report completed trades as a means of adding transparency to the market.¹⁹⁰

In January 2016, Treasury sought public comment on the ongoing evolution of the Treasury market and information on who are the primary drivers of this market restructuring and the implications of this change on liquidity and market functionality.¹⁹¹ It also sought comment on the need for additional data access and further reports to the public of transaction data.¹⁹² Concerns were also being expressed over a study that showed that high-frequency traders create an illusion of liquidity in the treasuries market.¹⁹³

IV. CONSOLIDATING REGULATION

A. Functional Regulation

The regulatory structure in the U.S. is based on a “functional” regulatory model in which the same financial product is regulated by a designated regulator wherever the product is traded.¹⁹⁴ For example, the SEC is assigned the regulation of securities trading, the CFTC is assigned the responsibility for regulating derivative instruments such as futures contracts, and banking regulators regulate banking activities.¹⁹⁵ As a Group of 30 Report notes:

Under the Functional Approach, supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of business may have its own functional regulator. For example, under a “pure” Functional Approach, if a single entity were engaged in multiple businesses that included banking, securities, and insurance activities, each of those distinct lines of business would be overseen by a separate, “functional” regulator.¹⁹⁶

189. *Id.*

190. Joe Renninson & Philip Stafford, *Pressure Builds for Change in Opaque Treasury Trading: Capital Markets*, FIN. TIMES (LONDON), Oct. 23, 2015, at 20.

191. Press Release, Dep’t of Treas., *Treasury Issues Requests for Information on Evolving Treasury Market Structure* (Jan. 19, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/j10323.aspx> [<https://perma.cc/NN84-AX82>].

192. *Id.*

193. Susanne Walker Barton, *High Frequency Trading, Fast Traders Create Illusion in Treasuries*: N.Y. Fed, 47 Sec. Reg. & L. Rep. (BNA) 1979 (Oct. 9, 2015).

194. See Melanie L. Fein, *Functional Regulation: A Concept for Glass-Steagall Reform?*, 2 STAN. J.L. BUS. & FIN. 89 (1995) (discussing functional regulation).

195. See Fein, *supra* note 194, at 89–91.

196. GRP. OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND

As the Group of 30 Report also notes, the functional regulator is “responsible for both safety and soundness oversight of the entity and business conduct regulation.”¹⁹⁷ Functional regulation thus contains two principal elements: (1) “prudential” regulation and (2) “business conduct.”¹⁹⁸ Both of these elements are carried out by a single designated regulator for each product.¹⁹⁹

“Prudential supervision has historically focused on the safety and soundness of individual financial firms, or, in the case of BHCs [bank holding companies], on the risks that an organization’s non-depository subsidiaries pose to its depository institution subsidiaries.”²⁰⁰ Prudential regulation includes “clear rules on criteria for entry, capital adequacy standards, asset diversification, limits on loans to insiders, permissible range of activities, asset classification and provisioning, external audits, enforcement powers, and failure resolution mechanisms.”²⁰¹

Prudential regulation may for example, require financial institutions to maintain a cushion of equity or liquid unencumbered funds.²⁰² Those requirements seek to assure that liquid funds will be available to meet customer demands in the event the institution encounters financial difficulties. Prudential regulation may also include prohibitions from engaging in speculative activities that might endanger the financial institution.²⁰³

In contrast to prudential regulation, business conduct regulations focus on activities by financial institutions that might harm customers or market participants such as misleading sales activities or manipulation of market prices.²⁰⁴

CHALLENGES IN A GLOBAL MARKETPLACE 24 (2008), http://group30.org/images/uploads/publications/G30_StructureFinancialSupervision2008.pdf [<https://perma.cc/CM7Z-NGGC>].

197. *Id.*

198. *Id.* at 38.

199. *Id.*

200. DEP’T OF TREAS., FINANCIAL REGULATORY REFORM, A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 26, https://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf [<https://perma.cc/6KM3-5GYU>] (last visited Nov. 21, 2016).

201. ECON. DEV. INST. OF THE WORLD BANK, FINANCIAL REGULATION: CHANGING THE RULES OF THE GAME 21 (Dimitri Vittas ed., 1992).

202. See, e.g., 17 C.F.R. § 240.15c3-1 (SEC net capital rule); 17 C.F.R. § 1.17 (CFTC net capital rule). The so-called Basel capital rules govern bank capital requirements and seek to assure that there is sufficient shareholder equity to act as a cushion in the event bank asset values fall below the amount of bank liabilities. See LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES: CASES AND MATERIALS 551–663 (4th ed. 2011) (describing the evolution of that capital requirement).

203. For example, the so-called “Volcker Rule” adopted by the Dodd-Frank Act in 2010 restricts banks’ propriety trading activities. See SIFMA, *Volcker Rule Resource Center*, <http://www.sifma.org/issues/regulatory-reform/volcker-rule/overview/> [<https://perma.cc/5ADK-E4P9>] (last visited Nov. 21, 2016) (describing Volcker Rule).

204. GRP. OF THIRTY, *supra* note 196, at 23.

“Business conduct regulation has a quite different focus from safety and soundness oversight. Its emphasis is on transparency, disclosure, suitability, and investor protection. It is designed to ensure fair dealing.”²⁰⁵ Business conduct regulation involves consumer protection, and antifraud and anti-manipulation measures, including consumer warnings concerning the risks of particular financial products.²⁰⁶ With respect to fraud, the SEC has broadly interpreted its general anti-fraud rule to proscribe everything from insider trading to misstatements of the risks of an investment.²⁰⁷ The CFTC and the SEC also bring enforcement actions against traders seeking to manipulate prices to an artificial level by market power or practices deemed to be improper.²⁰⁸

The business conduct cases brought by the CFTC and SEC are usually the result of lengthy investigations that may involve subpoenaed documents and witnesses.²⁰⁹ Their enforcement cases may be brought administratively or in federal court, where injunctions, large fines, and restitution may be demanded.²¹⁰ Prudential regulation rarely involves publicly announced enforcement actions, while business conduct regulation involves public enforcement proceedings that are often the subject of much publicity.²¹¹

Functional regulators have not generally proved adept at fulfilling the dual roles of prudential and business conduct regulation. Bank regulators focus on “safety and soundness” issues, which encompass fraud but focus more on financial stability issues that relate to prudential regulation.²¹² The bank regulators tend to work quietly with the banks through a continuous audit process in

205. *Id.*

206. *See, e.g.*, 17 C.F.R. § 1.55 (CFTC risk disclosure document required to be given to futures customers).

207. *See* JERRY W. MARKHAM & RIGERS GJYSHI, RESEARCH HANDBOOK ON SECURITIES REGULATION IN THE UNITED STATES, EDS., ch. 13 (2014) (describing the application of that rule).

208. *See* MARKHAM, *supra* note 5, at 252–57 (describing those prohibitions).

209. *See* Marc L. Steinberg & Ralph Ferrara, SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT 25 & 25A (2015) (describing the SEC enforcement process); Colleen P. Mahoney, et al., THE SEC ENFORCEMENT PROCESS: PRACTICE AND PROCEDURE IN HANDLING AN SEC INVESTIGATION (Bloomberg/BNA, Corporate Practice Series No.77-4th 2011) (same).

210. Mahoney, et al., *supra* note 209.

211. *Id.*

212. As one report notes:

Safety and soundness regulations for banks consist of basically five components: federal deposit insurance to reduce the likelihood of bank runs and panics; deposit interest ceilings to reduce the costs of bank deposits and weaken banks' incentives to invest in risky assets; regulatory monitoring to ensure that banks do not invest in excessively risky assets, have sufficient capital given their risk, have no fraudulent activities, and have competent management; capital requirements to provide incentives for banks not to take excessive risk; and portfolio restrictions to prohibit investment in risky assets.

which bank examiners seek to ferret out unsafe and unsound practices.²¹³ Although bank regulators may impose business restrictions for business misconduct, they do not typically employ investigative programs that seek to ferret out fraud.²¹⁴ In recent years, however, bank regulators have been piggybacking on CFTC and SEC cases where a bank is involved and fraud or price manipulation of a bank product is claimed.²¹⁵ This was done in the interest rate and foreign currency benchmark manipulation cases.²¹⁶ However, these multiple actions by multiple regulators for the same conduct serve no useful purpose.

In contrast, the SEC is primarily an “enforcement agency” for violations of business conduct requirements.²¹⁷ That agency is very aggressive in pursuing fraud, manipulation and business practices that might affect consumers. The CFTC has taken a similar approach. The model for both of those agencies is thus to seek headlines through high profile cases charging business misconduct.²¹⁸ Unfortunately, experience has proved that these regulators are not able to act effectively as both a prudential and business conduct regulator. For example, in an effort to impose prudential regulation over the large investment banks it regulated, the SEC adopted a Consolidated Supervised Entities system for assuring those firms remained viable in times of economic distress.²¹⁹ The result was disaster during the Financial Crisis in 2008 when all but two of those firms failed because of lack of capital or liquidity.²²⁰ The two survivors, Goldman Sachs and Morgan Stanley became chartered banks that are now regulated by banking authorities.²²¹ The CFTC also experienced some significant prudential failures that involved some of the largest futures commission merchants that it regulated.²²²

An SEC Chair admitted that the agency was ill-suited for the role of a prudential regulator, noting that such supervision “really required more of a bank-

WALTER W. EUBANKS, CONG. RES. SERV., RL33036, FEDERAL FINANCIAL SERVICES REGULATORY CONSOLIDATION: AN OVERVIEW 3 (2005) (emphasis omitted).

213. See BROOME & MARKHAM, *supra* note 202, at 570–75 (describing the goals of these examinations).

214. See *id.* at 577–82 (describing bank regulator enforcement powers).

215. See generally Jerry W. Markham, *Custodial Requirements for Customer Funds*, 8 BROOK. J. CORP. FIN. & COMM. L. 92, 106–08 (2013) (describing those failures).

216. See *supra* note 7 and accompanying text.

217. BERNAKE, *supra* note 84, at 250.

218. See generally *id.* at 95–96.

219. See generally *id.* at 250.

220. See generally *id.* at 260, 270.

221. *Id.* at 310–11.

222. See MARKHAM, *supra* note 215, at 108–23 (describing those failures).

ing regulators' sort of approach" instead of her agency's "disclosure and enforcement mentality."²²³ This is because prudential and business conduct regulation require different mindsets. The banking regulators have proved to be more adept at prudential regulation, but rarely bring any business conduct actions, preferring instead to gently admonish or ignore bad practices.²²⁴ This is exemplified by the preemption by bank regulators of state laws that sought to curb lending abuses in subprime lending before the Financial Crisis in 2008.²²⁵ After preempting some strong state measures that sought to curb such abuses, the bank regulators were accused of failing to take effective action on their own to deal with those problems before the exposure of widespread fraud and abuses in that market.²²⁶ Congress reacted to that laxity by including provisions in the Dodd-Frank Act in 2010 to limit the bank regulators' preemption powers in the future.²²⁷ However, Congress kept the banking regulators as business conduct regulators over such practices.²²⁸

B. Functional Regulation Has Been Undermined

At one time a functional regulatory system had some logical basis. For example, before the 1970s, futures trading was conducted largely on agricultural products that were of little interest to Wall Street broker-dealers and investment banks.²²⁹ This effectively walled off LaSalle Street from Wall Street in the trading of futures, and separate regulation possibly made some sense.²³⁰ Today, however, most futures and derivatives are traded on financial instruments.²³¹ History also drove the creation of functional regulation in other areas of finance. As a former Fed chairman Ben Bernanke has noted:

Historically, regulatory agencies were created ad hoc in response to crises and other events—the Office of the Comptroller of the Currency during the Civil War, the Federal Reserve after

223. BERNAKE, *supra* note 84, at 250–51 n.*.

224. See MARKHAM, *supra* note 35, at 396.

225. See *id.* at 396–98.

226. See Edmund Mierzwinski, *Preemption of State Consumer Laws: Federal Interference is a Market Failure*, 6 N.Y. BAR ASS'N, GOV. L. & POLICY J. 6–12 (Spring 2004) (describing this criticism).

227. See BROOME & MARKHAM, *supra* note 202, at 212.

228. See *id.*

229. U.S. SECURITIES AND INVESTMENTS REGULATION HANDBOOK 287 (Peter Farmery & Keith Walmsley, eds., 1992).

230. *Id.*

231. *Id.* at 287–88 (describing the change from the dominance of agricultural to financial derivatives).

the Panic of 1907, and the Federal Deposit Insurance Corporation and Securities and Exchange Commission (SEC) during the Depression. Politically, conflicts between competing power centers within government (congressional committees with overlapping jurisdictions, state versus federal regulators) and special interests, such as the banking and housing lobbies, have routinely blocked attempts to rationalize and improve the existing system.²³²

The “functional” system of regulation began to lose its luster as financial services became integrated over the years.²³³ As an SEC Chairman asserted in 1986:

[A]s a result of new economic opportunities and telecommunication technology, the traditional gaps between these industries have been bridged through major mergers and acquisitions and by new financial products and services - some of which compete on the basis of their regulatory classifications, rather than their economic merits.

Regulatory overlaps, duplications and conflicts have also multiplied. Today, 10 federal and over 100 state agencies regulate various aspects of the securities markets alone. Regulation of the securities registration and reporting requirements of about 400 publicly-owned banks and 300 savings and loan associations are divided among four federal agencies. Over 1,000 bank and S&L holding companies and the 10,000 other publicly-owned corporations file with the SEC.²³⁴

Former Fed chairman Ben Bernanke also noted that this functional regulatory system is also “highly fragmented and full of gaps.”²³⁵ “Important parts of the financial system . . . [are] inadequately overseen (if overseen at all) and, critically, no agency had responsibility for the system as a whole.”²³⁶ As another source notes:

232. BERNANKE, *supra* note 84, at 95.

233. John Shad, Chairman, SEC, Functional Regulation – The Concept and its Applications (May 21, 1986) (transcript available at <https://www.sec.gov/news/speech/1986/052186shad.pdf> [<https://perma.cc/Z7BN-RWQQ>]).

234. *Id.*

235. BERNANKE, *supra* note 84, at 94–95.

236. *Id.* at 95. Bernanke also noted that under the functional regulatory model:

The result was a muddle. For example, regulation of financial markets (such as the stock market and futures markets) is split between the SEC and the Commodity Futures Trading Commission, an agency created by Congress in 1974. The regulation of banks is dictated by the charter under which each bank operates. While banks chartered at the federal level, so-called national banks, are regulated by the OCC, banks chartered by state authorities are overseen by state regulators.

Regulation of Treasuries is splintered between the SEC, CFTC, Treasury, Federal Reserve and New York Fed. Though the agencies have been working together in recent months, they don't always get along. Each has its own interests and turf to protect.²³⁷

The haphazard nature of the present functional regulatory structure is particularly evident with respect to the insurance industry, which has no overall federal regulator.²³⁸ Instead, fifty states and the District of Columbia each have their own regulators, with their own rules and enforcement authorities that employ some 12,500 regulatory personnel.²³⁹ This regulation includes licensing, examinations, capital and reserve requirements, product regulation, and rate approval.²⁴⁰ Those state regulators try to coordinate their regulation through the National Association of Insurance Commissioners.²⁴¹ Nevertheless, differences remain. For example, some states require prior approval of health insurance rates, while others do not.²⁴²

The McCarran-Ferguson Act, which was passed in 1945, bars regulation of the insurance industry on the federal level.²⁴³ There were calls for federal regulation after the failure of several insurance companies during the last half of the twentieth century.²⁴⁴ However, the insurance industry has a strong lobby and has avoided such regulation.²⁴⁵ Still, functional regulation is not seamless in the insurance industry. For example, the SEC jointly regulates with the states

State-chartered banks that choose to be members of the Federal Reserve System (called state member banks) are also supervised by the Federal Reserve, with the FDIC examining other state-chartered banks. And the Fed oversees bank holding companies—companies that own banks and possibly other types of financial firms—independent of whether the owned banks are state-chartered or nationally chartered.

Id.

237. Ian Katz, *Financial Institutions, Treasury Market Anxiety and Signs of More Oversight*, 47 *Sec. Reg. & L. Rep. (BNA)* 2017 (2015).

238. NAT'L ASS'N OF INS. COMM'RS, *STATE INSURANCE REGULATION: HISTORY, PURPOSE AND STRUCTURE*, http://www.naic.org/documents/consumer_state_reg_brief.pdf [https://perma.cc/45K4-MPZF] (last visited Nov. 21, 2016).

239. *Id.*

240. *Id.*

241. *Id.*

242. *Id.*

243. 15 U.S.C. §§ 1011–1015 (2012).

244. MARKHAM, *supra* note 106, at 225.

245. *Id.* at 224–29.

variable annuity or other insurance products that tie payments to securities market performance.²⁴⁶ The SEC applies business conduct regulation to those products,²⁴⁷ but leaves to the states the task of conducting prudential regulation over those products.²⁴⁸ Adding to this patchwork of regulation is the application of the disclosure requirements in the federal securities laws to the issuance of stock by insurance companies to their shareholders. That role has increased in this century with the demutualization of many insurance companies.²⁴⁹

Many large insurance companies have also created operating affiliates that offer financial services outside their traditional insurance lines of business.²⁵⁰ Those affiliates may be regulated by the SEC or other functional regulator for particular products.²⁵¹ Some insurance companies also merged with other financial services as exemplified by the acquisition by General Electric of insurance companies and by the merger of Citigroup and the Travelers Insurance Co.²⁵² Regulation failed to keep pace with that transformation. This was evidenced by the failure of AIG during the Financial Crisis in 2008.²⁵³ AIG's losses resulted in a highly controversial \$182 billion bailout by the federal government because federal bank regulators thought that it posed a systemic risk to the economy.²⁵⁴

AIG was one of the largest international insurance companies, but it was brought down by the non-regulated activities of affiliates.²⁵⁵ AIG was able to evade regulation of its non-insurance affiliates by state insurance regulators.²⁵⁶

246. See *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) (holding that variable annuities are securities subject to SEC regulation); *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) (same); See also, 17 C.F.R. § 230.151(a) (SEC rule regulating such contracts).

247. See, e.g., *In re Waldon*, 80 SEC Docket 2877-10, 2003 WL 22032808 (Aug. 29, 2003) (respondent improperly switched clients in-and-out of variable annuities in order to increase his compensation); *In re Am. Skandia Inv. Serv. Inc.*, Exchange Act Release No. 2867, 2009 WL 1035191 (Apr. 17, 2009) (improper trading practices using variable annuity portfolios).

248. BAIRD WEBEL & RENA S. MILLER, CONG. RES. SERV., R40656, SECURITIES AND EXCHANGE COMMISSION RULE 151A AND ANNUITIES: ISSUES AND LEGISLATION 3-5 (2010) (noting that states rather than the SEC conducts prudential regulation).

249. See MARKHAM, *supra* note 106, 234-35 (describing that demutualization).

250. *Id.* at 233.

251. *Id.* at 232.

252. *Id.* at 235, 324.

253. Gretchen Morgenson, *Fresh Doubt Over the Bailout of A.I.G.*, N.Y. TIMES, (Dec. 20, 2014), <http://www.nytimes.com/2014/12/21/business/fresh-doubt-over-the-bailout-of-aig.html> [<https://perma.cc/FS6Q-DLPV>].

254. *Id.*

255. BERNANKE, *supra* note 84, at 271-72.

256. *Id.*

This was made possible because the AIG holding company owned a small savings and loan bank, which allowed the holding company structure to be supervised by the federal Office of Thrift Supervision (OTS).²⁵⁷ Regulation by OTS was ineffective, and it was abolished by the Dodd-Frank Act.²⁵⁸ In response to the AIG failure and other concerns, the Dodd-Frank Act also created a Federal Insurance Office (FIO) located in the Treasury that was given authority to monitor all aspects of the insurance sector and “to represent the United States on prudential aspects of international insurance matters, including at the International Association of Insurance Supervisors.”²⁵⁹

The FIO was also designated as a non-voting member of the Financial Stability Oversight Council (FSOC), the super-regulator created by Dodd-Frank to regulate systemically important financial institutions (SIFIs), including insurance companies.²⁶⁰ FSOC also has non-voting members that are representatives of state insurance, banking, and securities regulators.²⁶¹ To date, FSOC has designated three insurance companies as being systemically important.²⁶² The Financial Stability Board (FSB), which operates under theegis of the Group of Twenty (G-20) that coordinates regulation internationally, has also designated nine global insurers, including three in the U.S., as systemically important.²⁶³

The fact that all fifty states and the District of Columbia have separate regulators for their banking and securities, as well as insurance, businesses is inconsistent with the theory of functional regulation. That overlapping regulation has been ameliorated to some extent over the years by legislation or agency actions that preempt state regulation in areas heavily regulated at the federal level.²⁶⁴ For example, the National Securities Markets Improvement Act of 1996 preempted much of the state regulations previously imposed on broker-

257. *Id.*

258. *Id.* at 271–72, 463.

259. *About, Domestic Finance, Federal Insurance Office*, DEP’T OF TREAS., <http://www.treasury.gov/about/organizational-structure/offices/Pages/Federal-Insurance.aspx> [<https://perma.cc/5XGB-4E98>] (last visited Nov. 21, 2016).

260. Jerry W. Markham, *The Financial Stability Oversight Council—Risk Manager or Debating Society?*, 33 THE CAPCO INST. J. Fin. Trans. 35, 40–42 (Dec. 2011).

261. *Id.*

262. *Financial Stability Oversight Council*, DEP’T OF TREAS., <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> [<https://perma.cc/BRS7-7FU9>] (last visited Nov. 21, 2016). However, a federal district court rejected the designation of the insurer MetLife, Inc. as a SIFI. *MetLife, Inc. v. Fin. Stability Oversight Council*, 2016 U.S. Dist. LEXIS 46897 (D.D.C. Mar. 30, 2016).

263. *Global Systemically Important Insurers*, NAT’L ASS’N OF INS. COMM’RS (Jun. 15, 2016), http://www.naic.org/cipr_topics/topic_global_sys_insurers.htm [<https://perma.cc/9TE7-EM6Z>].

264. See MARKHAM, *supra* note 35, at 396–99.

dealers dealing in nationally traded securities.²⁶⁵ However, preemption raises concerns over state rights and the ability of federal regulators to provide comprehensive protection. Much criticism was directed at banking regulators for preempting state regulation of improper lending practices in subprime residential loans before the Financial Crisis in 2008.²⁶⁶ The Dodd-Frank Act sought to curtail such preemptive acts in the future.²⁶⁷

The functional regulation model at the federal level has also been substantially eroded over the years. For example, as noted above, the Government Securities Act of 1986 (GSA) required non-banks acting as broker-dealers in government securities to register with the SEC, while banks were subjected to regulation by the “appropriate regulatory agency.”²⁶⁸ At the same time, Treasury was assigned the task of adopting rules for the SEC regulated government securities dealers as well as for the banks.²⁶⁹ Those rules address the financial responsibility, protection of customer securities and balances, recordkeeping, and reporting of brokers and dealers in government securities.²⁷⁰ Treasury modeled those rules after existing SEC rules for broker-dealers that govern the protection of funds of customers.²⁷¹ Among other things, the Treasury’s capital rule allowed government securities broker-dealers registered with the SEC to comply with the SEC’s capital rule and financial institutions to comply with bank regulator capital requirements.²⁷²

The GSA also divided enforcement and examination authority over government securities dealers among the SEC, FINRA, and the appropriate bank regulatory authorities.²⁷³ However, the GSA continued to apply the anti-fraud and anti-manipulation prohibitions contained in the federal securities laws to all government securities brokers and dealers.²⁷⁴ This overlap was also apparent when the SEC and the Treasury Department announced in May 2016, that they were requesting FINRA to consider whether it could impose a requirement that

265. Nat’l Sec. Mkts. Improvement Act of 1996, Pub. L. No. 104-290, § 103, 110 Stat. 3416, 3420–21 (1996).

266. See MARKHAM, *supra* note 35, at 393–99 (describing that criticism).

267. Dodd-Frank Act, Pub. L. No. 111-203, § 1044, 124 Stat. 2014, 2015 (2010). See BROOME & MARKHAM, *supra* note 202, at 212–13 (describing that legislation).

268. 15 U.S.C. § 78o-5 (2012).

269. See Sec. Exch. Act of 1934, 17 C.F.R. §§ 400.1- (Treasury Department Regulations for government securities dealers and brokers).

270. *Id.*

271. See, e.g., Sec. Exch. Act of 1934, 17 C.F.R. § 403.4.

272. Sec. Exch. Act of 1934, 17 C.F.R. § 402.1.

273. DEP’T OF THE TREAS. J. REP. 1, *supra* note 1, at 9. Not all FINRA rules apply to government securities dealers registered with the SEC, such as those governing pricing and commissions. *Id.* at n.5.

274. *Id.* at 9.

registered broker-dealers report their Treasury cash market transactions to a centralized repository.²⁷⁵

This allocation of jurisdiction among multiple regulators breaches a basic principle of functional regulation, i.e., one product, one regulator for both prudential and business conduct. Instead, under the GSA, multiple regulators regulate the same product prudentially under their own rules, while the SEC was made the sole business conduct regulator in so far as the conduct involves fraud or manipulation.²⁷⁶

The GSA has not been the only breach of functional regulation. The foreign exchange market is regulated by multiple regulators that share both prudential and business conduct authority.²⁷⁷ The foreign exchange market is regulated by five U.S. regulators: the Commodities Futures Trading Commission (CFTC), the Securities and Exchange Commission (SEC), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Board of Governors of the Federal Reserve System (Fed).²⁷⁸ In recent years, they have filed coordinated and joint actions against several banks over currency manipulations that all made essentially the same charges.²⁷⁹ That market is also regulated internationally by U.S. and several foreign regulators, as well as the Basel Committee on Banking Supervision (Basel Committee) that was created by the Bank for International Settlements (BIS) in 1974.²⁸⁰

Another breakdown in functional regulation occurred in 1975 after Congress sought to resolve a jurisdictional war between the SEC and bank regulators over who would regulate the clearing and settlement of securities by banks.²⁸¹ Authority over clearing and settlement of securities was given to the “appropriate” bank regulator.²⁸² A sop was thrown to functional regulation by requiring the bank regulators and the SEC to consult with each other in proposing and adopting rules governing clearing and settlement activities.²⁸³

275. Press Release, SEC,¹ *Statement on Trade Reporting in the U.S. Treasury Market* (May 16, 2016), <https://www.sec.gov/news/pressrelease/2016-90.html> [<https://perma.cc/3Z3Z-V5PY>].

276. Markham, *supra* note 10, at 849.

277. *See id.* at 851.

278. *Id.* at 854.

279. *Id.* at 855–56.

280. BASEL COMMITTEE ON BANKING SUPERVISION, A BRIEF HISTORY OF THE BASEL COMMITTEE (Oct. 2015), <http://www.bis.org/bcbs/history.htm> [<https://perma.cc/UM3K-MMFQ>].

281. *See* Jerry W. Markham & Thomas Lee Hazen, *Broker-Dealer Operations and Regulation Under Securities and Commodities Laws*, SECURITIES LAW SERIES 23A § 13:2 (2d ed. 2014) (describing this jurisdictional fight).

282. *Id.*

283. 15 U.S.C. § 78q-1 (2012).

Functional regulation was struck another blow by the Commodity Futures Modernization Act of 2000, which granted joint jurisdiction to the SEC and CFTC over futures contracts traded on a single stock such as Apple.²⁸⁴ Legislation previously adopted in 1982 had allocated jurisdiction over derivatives traded on stock and other securities between the SEC based on the questionable functional regulatory claim that the SEC should regulate options on such indexes, while the CFTC would regulate futures and options on futures where the underlying instrument is a security index.²⁸⁵

Manipulation of the California energy market in 2000 and 2001 by Enron and other traders resulted in Congress assigning multiple regulators the same anti-manipulation authority that was modeled after the SEC's principal anti-fraud rule.²⁸⁶ Those agencies were the Federal Energy Regulatory Commission,²⁸⁷ the Federal Trade Commission,²⁸⁸ and the CFTC.²⁸⁹ Consequently, four regulators (CFTC, SEC, FERC, and FTC), plus the Justice Department, have the same powers for regulating energy price manipulations.²⁹⁰ Not surprisingly there were quickly jurisdictional battles over which agency's powers trumped the others.²⁹¹

The Dodd-Frank Act introduced another significant departure from functional regulation. It required most swaps to be centrally cleared and allocated jurisdiction over those previously unregulated swaps between the SEC and CFTC.²⁹² The SEC was given jurisdiction over security-based swaps, the CFTC was granted jurisdiction over commodity-based swaps, and joint regulatory authority was given to both agencies for "mixed" swaps, i.e., swaps having elements of both securities and commodities.²⁹³

Jurisdiction over the limited range of permitted uncleared commodity swaps was allocated between the CFTC and the appropriate banking regulatory agency where a bank is engaged in the swap transaction.²⁹⁴ Dodd-Frank allowed the Secretary of the Treasury to exempt foreign exchange swaps from

284. Consolidated Appropriations Act, 2001, Pub. L. No. 106-554, § 102, 114 Stat. 2763 (2000).

285. Securities & Exchange Commission, Jurisdiction Clarification, Pub. L. No. 97-303, § 2, 96 Stat. 1409 (1982).

286. 17 C.F.R. § 240.10b-5 (2016).

287. Energy Policy Act of 2005, Pub. L. No. 109-58, § 1283, 119 Stat. 594.

288. See Energy Independence and Security Act of 2007, Pub. L. No. 110-140, 121 Stat. 1492.

289. Dodd-Frank Act, Pub. L. No. 111-203, § 753, 124 Stat. 1750-54 (2010).

290. Markham, *supra* note 10, at 852.

291. *Hunter v. FERC*, 711 F.3d 155, 156-57 (D.C. Cir. 2013) (describing one such fight).

292. Jerry W. Markham, *Regulation of Swap and Other Over-The-Counter Derivative Contracts*, Bloomberg (BNA) Securities Practice Portfolio Series No. 263 at p. A-17 (2014).

293. *Id.* at A-17.

294. *Id.* at A-18.

the definition of “swap” for most regulatory purposes, including margin and central clearing requirements.²⁹⁵ The Treasury Secretary announced that he had made the determination to make that exemption on November 20, 2012.²⁹⁶

In still another move away from functional regulation, Dodd-Frank created a new Consumer Financial Protection Bureau (CFPB), which acts as an autonomous unit in the Fed.²⁹⁷ The CFPB is responsible for adopting and enforcing consumer protection regulations.²⁹⁸ However, its enforcement and examination responsibilities were limited to the larger banks, while the Fed, the OCC, and the FDIC were given that responsibility for smaller banks, i.e., those with assets of \$10 billion.²⁹⁹ The result is multiple regulators regulating products for different institutions under the same statutes. Although housed under the umbrella of the Fed’s budget, the CFPB is independent of any oversight by the Fed.³⁰⁰ This means that there are two regulators in the Fed assigned the same task of enforcement but for different institutions, which completely ignores the theory of functional regulation.³⁰¹

C. “Twin Peaks” Regulation

The Government Accountability Office (GAO) noted in 2016 that fragmentation and overlap in the regulation of financial services “have created inefficiencies in regulatory processes, inconsistencies in how regulators oversee similar types of institutions, and differences in the levels of protection afforded to consumers.”³⁰² The rest of the world had elected not to take the haphazard American approach to regulation that involves multiple regulators for the same parties. In England and other countries, financial services regulation has been divided along the lines of prudential and business conduct regulation, the so-

295. See Dodd-Frank Act, Pub. L. No. 111-203, § 721, 124 Stat. 1658, 1668–69 (2010).

296. Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69,694 (Nov. 20, 2012).

297. BERNANKE, *supra* note 84, at 463.

298. See *About Us*, CFPB, <http://www.consumerfinance.gov/the-bureau/> [<https://perma.cc/B44T-UQQA>] (last visited Nov. 21, 2016) (describing the role of the CFPB).

299. See BERNANKE, *supra* note 84, at 447 (describing this allocation of jurisdiction).

300. *Id.* at 463.

301. Ken Baebel & John C. Soffronoff, Jr., *Introducing the Consumer Financial Protection Bureau*, American Banking Association, available at <https://www.aba.com/Products/bankcompliance/Documents/NovDec10CoverStory1.pdf> [<https://perma.cc/AV3F-TBUH>] (accessed on Dec. 13, 2015).

302. GAO, *Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness*, GAO-16-175 (Mar. 28, 2016), <http://www.gao.gov/products/GAO-16-175> [<https://perma.cc/9YGS-MSR4>].

called “Twin Peaks” approach to regulation.³⁰³ The Bank of England is responsible for the former and the Financial Conduct Authority for the latter in England.³⁰⁴ In contrast, the multi-regulator and multi-layered structure of the financial regulatory system in the United States is unlike that of England or any other nation.

A Treasury study and report that was completed in 2008 recommended that the U.S. abandon functional regulation in favor of a system of combined regulation that would take a “Three Peaks” approach.³⁰⁵ The Treasury regulatory reform proposal thus sought the creation of a regulatory system that would have involved (1) a market stability regulator that would set monetary policy and monitor systemic economic regulatory issues; (2) a prudential financial regulator for government insured banks and broker-dealers that would adopt rules for the protection of those industries government insurance funds; and (3) a business conduct regulator that would regulate business conduct across all financial services.³⁰⁶

The market stability regulator would have had responsibility for implementing monetary policy and providing liquidity to financial institutions, a role that is filled by the Fed and that would have continued under the Treasury reform proposal.³⁰⁷ The prudential financial regulator would have been responsible for the regulation of financial institutions that are protected by the Federal Deposit Insurance Corporation (FDIC) in the case of banks, or the Securities Investors Protection Corporation (SIPC) for broker-dealers. This prudential regulation would have included capital adequacy requirements, investment and activity restrictions, and on-site risk management supervision.³⁰⁸

The proposed business conduct regulator would regulate business conduct across all types of financial firms. The Treasury recommended the consolidation of the CFTC and SEC as an interim step in creating a single business conduct regulator.³⁰⁹ Regulated business conduct would have included disclosures required to be made to consumers, business practices, and licensing, where appropriate, of financial services firms.³¹⁰

303. US. GOV'T ACCOUNTABILITY OFF., GAO-16-175, FINANCIAL REGULATION: COMPLEX AND FRAGMENTED STRUCTURE COULD BE STREAMLINED TO IMPROVE EFFECTIVENESS 65 (2016).

304. See generally DEP'T OF TREAS., BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 3 (2008); Markham, *supra* note 10, at 862.

305. DEPT. OF TREASURY, *supra* note 304, at 139–44.

306. *Id.* at 144.

307. *Id.* at 137.

308. *Id.* at 137–38.

309. *Id.* at 106–11.

310. *Id.* at 138.

Unfortunately, the Financial Crisis of 2008 derailed Treasury's reform efforts. Instead, a Treasury white paper urged the CFTC and SEC to consider proposing legislation that would harmonize their regulation or justify any differences.³¹¹ "In its June 2009 white paper on financial regulatory reform, Treasury noted that the broad public policy objectives of futures and securities regulation are the same and that many of the differences in the regulation of the markets are no longer justified."³¹² Thereafter, the CFTC and SEC issued a joint report describing the differences in their regulations and the legislation needed for harmony.³¹³ That report laid the groundwork for harmonization and eventually consolidation, but, as described above, Dodd-Frank continued the process of diverting from functional regulation to a system of multiple regulators regulating the same product.³¹⁴

Recommendations for the consolidation of the SEC and CFTC had failed in the past because jurisdiction over those agencies was divided between Congressional agriculture committees for the CFTC and banking and finance committees for the SEC.³¹⁵ However, that division of oversight responsibility has been an anachronism for decades because financial derivatives now almost completely dominate the futures markets that once were limited to agricultural based futures contracts.³¹⁶ It simply no longer makes sense to divide congressional jurisdiction on such grounds. Perhaps this barrier could be breached by creating new congressional committees that would be composed of members of both the agricultural and banking and finance committees in the House and Senate.

The futures industry had also previously rejected SEC style inside information and other regulatory theories and, therefore, did not want to fall within the reach of that aggressive agency's enforcement programs.³¹⁷ However,

311. DEP'T OF THE TREAS., *supra* note 200, at 50–51.

312. U.S. GOV'T ACCOUNTABILITY OFF., GAO-10-410, FINANCIAL REGULATION: CLEARER GOALS AND REPORTING REQUIREMENTS COULD ENHANCE EFFORTS BY CFTC AND SEC TO HARMONIZE THEIR REGULATORY APPROACHES 6 (2010).

313. CFTC & SEC, A JOINT REPORT OF THE SEC AND THE CFTC ON HARMONIZATION OF REGULATION 24–25 (Oct. 16, 2009) (ex. 69) ("Joint Report").

314. *Id.* at 45.

315. See BERNANKE, *supra* note 84, at 444 (describing that jurisdictional split and its barriers to consolidation of SEC and CFTC).

316. By 1990, financial futures accounted for about 75 percent of the futures business, and the U.S. Treasury bond futures contract was then the most heavily traded futures contract in the world. MARKHAM, *supra* note 106, at 162.

317. See Jerry W. Markham, *Merging the SEC and CFTC—A Clash of Cultures*, 78 U. CIN. L. REV. 537, 544–48 (2009) (describing these hurdles.); Jerry W. Markham, *Super Regulator: A Comparative Analysis of Securities and Derivatives Regulation in the United States, The United Kingdom & Japan*, 28 BROOK. J. INT'L L. 319, 397–98 (2003) (same).

Dodd-Frank and other legislation have walled off the application of inside information theories to futures trading.³¹⁸ Moreover, there has been a sea change in the politics of futures regulation. The powerful exchanges in Chicago and New York that once lobbied Congress on behalf of the futures industry have been largely consolidated into two entities, i.e., the CME Group and the Intercontinental Exchange (ICE).³¹⁹ Before the consolidation by the CME, the futures exchanges were member owned and largely controlled by their local floor members who fiercely fought against any form of SEC style regulation.³²⁰ However, consolidation of the futures exchanges was attended by demutualization and the growth of electronic trading.³²¹

Demutualization meant that the CME had a new constituency in the form of public shareholders and that it is now regulated as a public company by the SEC.³²² To be sure, the current CME leadership are from the older era, but they are no longer beholden to floor members. This is because the growth of electronic trading also led to the closure of most trading floors.³²³ This means that the floor members are no longer in a position to maintain control of the exchange. They also lost their power to control the lobbying efforts of the exchange.

The new electronic traders, for the most part, do not favor more regulation, but many of those traders are familiar with the SEC and its regulation and do not have the same fierce opposition to that regulation as once held by floor traders.³²⁴ In that regard, the other large operator of U.S. futures options exchanges, i.e., ICE, which began in 2000, had as its backers several large investment banks, including Goldman Sachs and Morgan Stanley, which have been long accustomed to SEC regulation.³²⁵ Consequently, the old futures industry exchange culture is fast becoming extinct. Moreover, the CFTC had become a more aggressive agency in policing manipulation and other trading abuses through the Dodd-Frank legislation that gave it the same anti-fraud authority as the SEC, less insider trading prohibitions.³²⁶ The CFTC was, unlike the SEC,

318. See Dodd-Frank Act, Pub. L. No. 111-203, § 753, 124 Stat. 1750 (2010).

319. See CME GROUP, <http://www.cmegroup.com> [<https://perma.cc/S6B4-BAZZ>] (last visited Nov. 21, 2016) (describing CME operations); INTERCONTINENTAL EXCHANGE, <https://www.intercontinentalexchange.com/index> [<https://perma.cc/A3ZG-VMF4>] (describing ICE's operations).

320. MARKHAM, *supra* note 5, at 347.

321. *Id.*

322. *Id.* at 347–48.

323. *Id.* at 7.

324. *Id.*

325. *Id.* at 347.

326. *Id.* at 326.

once friendly to speculators who brought liquidity and more efficient pricing to the markets.³²⁷ Today, the CFTC is aggressively attacking speculators and is seeking headline-grabbing cases that have long been the forte of the SEC.³²⁸

In any event, the merger of the SEC and CFTC would create a natural single business conduct regulator over the U.S. Treasury market. Indeed, as described above, the two agencies are already largely fulfilling that role, but as separate agencies. Still, apart from the politics of such a consolidation, there are numerous practical issues to be considered in merging those agencies. For example, there needs to be strong representation on the consolidated commission from both the futures and securities industries. Although cultural differences in the futures and securities markets are fast being obliterated, such representation would provide additional expertise in futures trading and knowledge of the nuances in their regulation, such as for inside trading. That integration could be accomplished by requiring at least two members of a five-member commission to have strong futures industry backgrounds and two with strong securities industry experience. A third commissioner should be required to have strong exposure to both industries, which is not that unusual today since, as noted, the two markets have gradually become intertwined with each other.

Another issue is staffing for the merger of the CFTC and SEC. It is unlikely that a merger would result in much of a reduction in enforcement staff because the combined mission is no less than for the existing division of labor. However, some reduction could be effected in the commissioners' offices because their number and staff would be cut in half in a combined agency. Similarly, savings could be achieved by eliminating duplicate human resources, governmental affairs, information technology, the Secretariat, and public relations staff.

The futures and securities industries would also have lessened burdens from dealing with a single agency instead of the existing two agencies that have often been at odds with each other over regulation. However, combining the agencies may have the effect of creating a monolith bureaucracy that may be even more costly in the form of additional regulations that one or the other of the agencies would not have adopted if it were independent. As noted, the SEC became a zealous regulator beginning in the 1960s, and the CFTC has recently adopted a similar stance.³²⁹ In that regard, the SEC has long been accused of overreaching

327. *Id.* at 339.

328. *Id.* (describing the transformation of the CFTC into a more aggressive regulator).

329. ROBERTA S. KARMEI, REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA 193 (1982).

by seeking to create new regulations through novel litigation claims.³³⁰

The SEC has also recently sought to tilt the table in its favor by bringing cases before its own administrative law judges (ALJs) where its success rate is substantially higher than for the cases it brings in federal court.³³¹ These administrative proceedings may be likened to “kangaroo courts” because the CFTC and SEC and their employees are the judge, who is also the jury, and the prosecutor from the agencies’ enforcement divisions.³³² The ALJs have their offices in the SEC building and have been admonished by the SEC’s chief ALJ to be loyal to the agency by ruling in favor of the SEC.³³³ As one federal judge also noted, “[t]he SEC appoints the judges, the SEC pays the judges, they are subject to appeal to the SEC”³³⁴

The one-sided nature of these proceedings is exemplified by the fact that the SEC’s success rate in administrative proceedings is substantially higher than is the case for actions it brings in federal court (ninety percent in ALJ administrative decisions versus sixty-nine percent in federal court during one recent five-year period).³³⁵ The situation worsens when a respondent appeals from an adverse decision from an ALJ to the SEC. During the same five-year period, the SEC upheld its ALJs decisions ninety-five percent of the time and often increased penalties over those imposed by the ALJ, which of course discourages appeal.³³⁶

Judicial review of SEC/CFTC administrative decisions is also quite limited. Presently, the standard for judicial review is that the CFTC and SEC administrative decisions need only be supported by the “weight” or “preponderance” of the evidence.³³⁷ This is equated to proof that it is more likely than not that

330. See, e.g., *id.* at ch. 6.

331. Several challenges have been mounted recently contending that the SEC’s administrative proceedings are unfair and that ALJs are not appointed correctly as required by the Constitution. Rob Tricchinelli, *Jurisdiction and Procedure: More Circuit Court Action on SEC’s In-House Forum*, 47 SEC. REG. & L. REP. (BNA) 1942 (2015).

332. See, e.g., Jean Eaglesham, *SEC Wins With In-House Judges*, WALL ST. J. (May 6, 2015), <http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803> [<https://perma.cc/8SNF-V2W4>].

333. Several challenges have been mounted recently contending that the SEC’s administrative proceedings are unfair and that ALJs are not appointed correctly as required by the Constitution. *Id.*

334. *Id.*

335. See, e.g., *id.* Indeed, one SEC ALJ hearing numerous cases over a four-year period had never ruled fully in favor of a respondent. *Id.*

336. *Id.*

337. See, e.g., *Steadman v. SEC*, 450 U.S. 91, 1008 (1981) (adopting a preponderance test and rejecting clear and convincing evidence standard); *Reddy v. CFTC*, 191 F.3d 109, 117 (2d Cir. 1999) (“our role in reviewing the Commission finding of preponderance is narrow.”).

the defendant committed a violation. This is a far lower standard than the requirement of proof beyond a reasonable doubt required to be shown in criminal cases.

The penalties imposed in SEC and CFTC administrative proceedings do not include imprisonment, but civil sanctions can be substantial. Such sanctions include large fines, bars from the securities industry or futures trading, and revocation of licenses needed to do business in either industry.³³⁸ The severity of those sanctions should demand a higher level of proof than civil actions seeking recovery of damages that apply the more likely than not standard. Since these sanctions are penalties, not damages, it would seem appropriate to impose the criminal standard of beyond a reasonable doubt.³³⁹

Alternatively, a standard in between the existing preponderance standard and the criminal standard is that of clear and convincing evidence. That is, the government would be required to offer proof that a fact finder would find was clear and convincing evidence that a defendant committed a violation.³⁴⁰ In order to achieve acceptance, a single business regulator should be held to such a higher standard of proof in bringing actions that can ruin careers, even if not ultimately successful, because of the adverse publicity generated on filing.

SEC and CFTC administrative proceedings are also marked by the fact that discovery is more limited than is available in proceedings in federal court, and there is no ability to demand a jury trial in administrative proceedings.³⁴¹ Those

338. As the SEC website notes:

Depending on the statutory basis for the proceeding, an administrative law judge may order sanctions. Such sanctions include cease-and-desist orders; investment company and officer-and-director bars; censures, suspensions, limitations on activities, or bars from the securities industry or participation in an offering of penny stock; censures or denials of the privilege of appearing or practicing before the Commission; disgorgement of ill-gotten gains; civil penalties; and suspension or revocation of an issuer's registered securities, as well as the registration of a broker, dealer, investment company, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization. An administrative law judge may also order that a fair fund be established for the benefit of persons harmed by a respondent's violations.

Office of Administrative Law Judges, SEC.GOV, <http://www.sec.gov/alj> [<https://perma.cc/G82N-PCJ2>] (last visited Nov. 21, 2016).

339. See generally *United States v. Halper*, 490 U.S. 435, 446 (1989) (civil penalties may violate double jeopardy clause of the constitution).

340. See Gordon K. Eng, *The Burden of Proof in SEC Disciplinary Proceedings: Preponderance and Beyond*, 49 FORDHAM L. REV. 642, 646 (1981) (discussing these issues).

341. Hazel Bradford, *SEC Administrative Overhaul Welcomed, but Critics Seek More*, PENSIONS & INVESTMENTS (Dec. 14, 2015), <http://www.pionline.com/article/20151214/PRINT/312149944?AllowView=VDI3UXlwSzdDL0NCZ2dIRkN2YnRIRUtyamtnZE>

limitations should be corrected.³⁴² In addition, the SEC/CFTC commissioners approve of the filing of the administrative complaint before it is filed.³⁴³ This means that the agency has decided that the conduct in question is a violation, and ALJs are not allowed to make an independent judgment as to whether the administrative complaint actually sets forth a cognizable claim.³⁴⁴ That limitation varies dramatically from the commonly used motion to dismiss that is available in federal court.³⁴⁵

As noted, if successful, the government will seek and impose enormous fines and trading restrictions against respondents in administrative proceedings.³⁴⁶ There should also be consequences when the government fails to prove these administrative cases, especially in view of the one-sided nature of these proceedings. In fairness, successful respondents should have their attorney fees and expenses reimbursed by the government. In that regard, the existing Equal Access to Justice Act sets too high a bar for attorney fee reimbursement since it requires the defendant to show that the government's action was not substantially justified.³⁴⁷ That standard should be modified to awarding fees when the respondent substantially prevails in an SEC/CFTC administrative proceeding. Additionally, a defendant that prevails in action brought by the business conduct regulator should be given damages for lost wages, reputational losses, and compensation for the disruption of their lives. If these changes cannot be made, then the present one-sided administrative proceedings should be barred except in cases of consent judgments.

D. Prudential Regulation

The second prong for reforming regulation of the U.S. Treasury market is assigning prudential regulation to a single regulator. As described above, the SEC/CFTC are not effective in creating or administering such regulation and

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[<https://perma.cc/3Q45-NQZ7>].

342. The SEC has proposed changes to its rules that would allow depositions of witnesses and expert witness testimony, but would place limitations on the timing of such discovery that do not exist in federal court proceedings. *Id.*

343. *Id.*

344. See, e.g., *In re Siegel Trading Co.*, CFTC No. 77-1, Comm. Fut. L. Rep. (CCH) ¶ 20, 637 (June 21, 1978).

345. See FED. R. CIV. P. 12(b)(6).

346. See generally *Office of Administrative Law Judges*, SEC.gov, <http://www.sec.gov/alj> [<https://perma.cc/G9P4-DVPA>] (last visited Nov. 21, 2016).

347. 28 U.S.C. § 2412(d)(1)(A) (2012). See, e.g., *Frey v. CFTC*, 931 F.2d 1171, 1176 (7th Cir. 1991) (discussing the applicable standards for awarding attorney fees under that statute).

have little interest in doing so, preferring their business conduct role instead.³⁴⁸ Consequently, a separate, more-qualified prudential regulator is needed for the U.S. Treasury market. The Fed should continue to set monetary policy, but a prudential regulator is needed to resolve dealers when they become insolvent, and such a regulator should create, and examine compliance with, capital and custody requirements for Treasury dealers.

The prudential financial regulator presently responsible for resolving insolvent banks is the FDIC.³⁴⁹ It operates outside the normal bankruptcy process for commercial corporations.³⁵⁰ The FDIC is authorized to seize control of institutions it insures when they are insolvent, to sell the institution or its assets and to then pay off depositors for any shortfalls in amounts up to the statutory insurance limit.³⁵¹ This process happens very quickly, often resulting in the bank carrying on its operations under a new owner with little or no delay in depositor access to their funds.³⁵²

SIPC is responsible for regulated broker-dealers that become insolvent.³⁵³ Those liquidations are carried out under the Securities Investor Protection Act of 1970.³⁵⁴ The SIPC trustee will transfer customer funds and securities to solvent broker-dealers and then pay customers for any shortfalls up to the insurance limit.³⁵⁵ In contrast, customer accounts of insolvent FCMs that fall within the regulatory purview of the CFTC are not protected by government account insurance.³⁵⁶ Nevertheless, the bankruptcy code and CFTC rules have special rules that govern the bankruptcy of a FCM.³⁵⁷ Those bankruptcies are carried out much in the manner of the bankruptcy of a commercial firm, except that special provisions are made for the priority of customer claims and the transfer

348. See generally GAO, *supra* note 302.

349. Rosalind L. Bennett, *Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers*, FDIC BANKING REVIEW 3, <https://www.fdic.gov/bank/analytical/banking/2001sep/article1.html> [<https://perma.cc/CC6G-AKUT>] (last visited Nov. 21, 2016) (describing this resolution process).

350. *Id.* at 7.

351. *Id.* at 16.

352. *Id.* at 13.

353. 15 U.S.C. §§ 78ccc(b), 78eee(3)(B) (2012).

354. Securities Investor Protection Act of 1970, Pub. L. No. 91-598, 84 Stat. 1636 (1970) (codified at 15 U.S.C. § 78aaa through 15 U.S.C. § 78lll).

355. See U.S. Courts, *Securities Investor Protection Act (SIPA)*, <http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/securities-investor-protection-act-sipa> [<https://perma.cc/U4J2-NHC3>] (last visited Nov. 21, 2016) (describing this process).

356. Efforts to create such an insurance program have failed in the past. See Markham, *supra* note 215, at 127–29 (describing those efforts).

357. U.S. Bankruptcy Code, 17 C.F.R. Pt. 190, App. B.

of customer positions and assets to solvent FCMs.³⁵⁸

The prudential financial regulator would presumably replace the SECs present net capital rule with its own capital requirements.³⁵⁹ This would create an anomaly with the CFTC, which has its own net capital rule.³⁶⁰ As noted, CFTC regulated FCMs are not covered by account insurance.³⁶¹ Even so, the prudential regulator could be assigned the task of implementing capital requirements for futures commission merchants (FCMs), which are the equivalent of the broker-dealers that are regulated by the SEC and have a capital rule similar to the one imposed by the CFTC on FCMs.³⁶²

A problem to be faced is what responsibility the prudential regulator will have over implicit government guarantees. For example, money market funds were guaranteed against loss during the Financial Crisis in 2008.³⁶³ The Exchange Stabilization Fund that was created during the Great Depression in the 1930s as a means to stabilize the dollar against other currencies was used in 2008 to stop a panic by investors in money market funds after one of those funds experienced losses from Lehman Brothers commercial paper after it failed.³⁶⁴ Another implicit guarantee was found in Fannie Mae and Freddie Mac mortgage-backed securities that became explicit after the government seized control of those entities during the Financial Crisis in 2008.³⁶⁵ If privatized again in the future, then the implicit guarantee concern will arise again.

The Dodd-Frank Act sought to eliminate any implicit guarantee of “too-big-to-fail” financial institutions like AIG through the creation of FSOC.³⁶⁶ That super regulatory body designates systemically important financial institutions, subjects them to oversight by the Fed, and requires them to have a “living will” for their orderly liquidation in the event of bankruptcy.³⁶⁷ However, this new system is untried and the prudential regulator would need to be given a large role in that process.

Still another area of concern is custody requirements for customer funds

358. U.S. Bankruptcy Code, 11 U.S.C. §§ 765–766.

359. 17 C.F.R. § 240.15c3-1.

360. 17 C.F.R. § 1.17.

361. *Id.*

362. *See* 17 C.F.R. § 240.15c3-1(a)(1)(iii).

363. *See* BERNANKE, *supra* note 84, at 250, 301–02.

364. *Id.* at 301–02.

365. *Id.* at 206–07.

366. *Id.* at 462.

367. *Id.*

and securities. Presently there are separate regimes for such requirements imposed by bank regulators, the SEC and CFTC.³⁶⁸ The issue here is where should such authority be centralized, i.e., in the prudential financial regulator or in the business conduct regulator? It would seem that the former might be best suited for task since capital requirements go hand-in-hand with custodial requirements in that both seek to assure that the financial institution can meet customer demands for cash.³⁶⁹ Custodial requirements seek to protect customer funds from the claims of other creditors, while capital requirements seek to assure that the financial institution has the requisite liquidity to meet customer demands.³⁷⁰

V. CONCLUSION

Functional regulatory theory needs to be abandoned in favor of a consolidated business conduct regulator over the Treasury market. This would be a meaningful step toward the creation of a more streamlined and efficient regulatory system that would be administered by a single business conduct regulator tasked with monitoring and policing abuses in critical markets.

368. See Markham, *supra* note 215 (describing those regulatory schemes).

369. See 23 JERRY W. MARKHAM, *BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAWS*, Ch. 4–5 (2015 ed.).

370. See *id.* (describing SEC and CFTC custodial and net capital requirements).